

An Analysis of the President's Budgetary Proposals for Fiscal Year 2007



MARCH 2006

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Notes

Unless otherwise indicated, the years referred to in this report are fiscal years.

Numbers in the text and tables may not add up to totals because of rounding.

Supplemental data for this analysis are available on the home page of the Congressional Budget Office's Web site (www.cbo.gov), under "Current Budget Projections," and are posted along with the report *Preliminary Analysis of the President's Budget Request for 2007* (March 3, 2006).



Preface

This Congressional Budget Office (CBO) analysis of the President's budgetary proposals for fiscal year 2007—prepared at the request of the Senate Committee on Appropriations—was produced by the staffs of CBO's Budget Analysis, Macroeconomic Analysis, and Tax Analysis Divisions under the supervision of Robert Sunshine, Robert Dennis, and Thomas Woodward, respectively. CBO prepared the baseline revenue estimates and the estimates of selected revenue proposals; the Joint Committee on Taxation prepared most of the estimates of the President's revenue proposals. This report expands on CBO's preliminary analysis, which was released on March 3, 2006.

Barry Blom of CBO's Projections Unit was the lead author for Chapter 1; Mark Booth, Pamela Greene, and Christina Hawley Sadoti wrote major portions of the chapter. Ben Page of the Macroeconomic Analysis Division wrote Chapter 2 and Appendixes B and C, with assistance from Robert Arnold, Paul Burnham, Ufuk Demiroglu, Eva de Francisco, Mark Lasky, Larry Ozanne, and Frank Russek. Ann Futrell of the Projections Unit wrote Appendix A. The contributors to the revenue and spending projections underlying this report are listed in Appendix D.

Leah Mazade and Christian Spoor edited the report, with assistance from Christine Bogusz and Loretta Lettner. Maureen Costantino took the photograph for the cover and prepared the report for publication. Lenny Skutnik produced the printed copies.

Donald B. Marron
Acting Director

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CBO's Estimates of the President's Budget for Fiscal Year 2007

At the request of the Senate Committee on Appropriations, the Congressional Budget Office (CBO) has analyzed the President's budget request for fiscal year 2007 using its own economic assumptions and estimating techniques.¹ The analysis also incorporates the Joint Committee on Taxation's (JCT's) estimates for provisions that affect the tax code. This report provides more detail and analysis about the President's budgetary proposals—and about CBO's updated baseline budget projections—than did the preliminary report that CBO released on March 3.

Overview of CBO's Estimates

The President's proposals would add \$35 billion to the deficit that CBO currently projects for 2006, reducing revenues by nearly \$9 billion and boosting outlays by \$27 billion (mostly for military operations in Iraq and Afghanistan). If those proposals were enacted, the deficit would total \$371 billion this year, CBO estimates (see Table 1-1). Relative to the size of the economy, this year's deficit would equal 2.8 percent of gross domestic product (GDP). By comparison, the deficit in 2005 was \$318 billion, or 2.6 percent of GDP.

Estimates for the 2007-2016 Period

In 2007, the deficit would total \$335 billion under the President's budgetary proposals, CBO estimates. However, the amount that the President has requested to fund ongoing U.S. operations in Iraq and Afghanistan for that year (\$50 billion) may not be sufficient. If the pace of those operations remained at about this year's level, the

deficit in 2007 would be around \$355 billion, or 2.6 percent of GDP.

After 2007, the deficit would continue to decline as a percentage of GDP under the President's proposals—to 1.6 percent in 2008 and 1.3 percent in 2009, CBO estimates, before stabilizing at around 1.0 percent through 2016 (see Figure 1-1). Those deficits would total \$2.1 trillion, or 1.2 percent of GDP, between 2007 and 2016 (the current 10-year projection period). Federal debt held by the public would grow from 37.4 percent of GDP at the end of 2005 to 38.5 percent at the end of 2007. It would then gradually fall to 34.5 percent of GDP by 2016. However, those figures do not reflect any additional funding for military activities in Iraq and Afghanistan beyond 2007.

The President's budget does not contain year-by-year estimates of spending and revenues after 2011. Instead, it provides a cumulative estimate through 2016 for each proposed change to laws that govern revenues and mandatory spending. For discretionary spending, the budget provides details only for 2006 and 2007; for 2008 through 2011, such funding is shown in the aggregate, by budget function.² CBO incorporated those aggregate levels in its estimates and calculated discretionary outlays for the 2012-2016 period by projecting the amount of discretionary budget authority that the President recommended for 2011 and adjusting it for inflation.

Total outlays would remain at more than 20 percent of GDP this year and next year under the President's budget, close to their average of 20.5 percent since 1965. Thereafter, total outlays would decline to around

1. The analysis covers the budget that the President submitted on February 6 as well as the detailed requests for supplemental funding that were transmitted on February 16, primarily for military operations in Iraq and Afghanistan and hurricane recovery.

2. Budget functions are the broad categories into which the federal budget is divided so that all budget authority and outlays can be presented according to the national interests they address (such as defense, agriculture, transportation, and so forth).

Table 1-1.

Comparison of Projected Deficits and Surpluses in CBO's Estimate of the President's Budget and in CBO's March Baseline

(Billions of dollars)

	Actual												Total, 2007-	Total, 2007-
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2011	2016
CBO's Estimate of the President's Budget for 2007														
On-Budget Deficit	-493	-551	-527	-448	-422	-410	-447	-389	-414	-412	-412	-450	-2,255	-4,332
Off-Budget Surplus ^a	175	180	192	213	228	245	244	231	218	214	208	200	1,123	2,195
Total Deficit	-318	-371	-335	-236	-194	-165	-204	-158	-195	-197	-204	-250	-1,133	-2,137
CBO's Baseline														
On-Budget Deficit	-493	-516	-460	-466	-456	-465	-382	-216	-227	-211	-198	-220	-2,228	-3,300
Off-Budget Surplus ^a	175	180	195	215	232	249	265	274	280	286	288	290	1,156	2,574
Total Deficit (-) or Surplus	-318	-336	-265	-250	-224	-216	-117	58	53	74	91	70	-1,072	-726
Difference (President's budget minus baseline)^b														
On-Budget Deficit	0	-35	-67	17	34	54	-66	-174	-186	-201	-214	-230	-27	-1,031
Off-Budget Surplus ^a	0	0	-3	-3	-3	-4	-21	-42	-62	-71	-80	-90	-33	-380
Total Deficit or Surplus	0	-35	-70	15	31	50	-86	-216	-249	-272	-294	-320	-61	-1,411
Memorandum:														
Total Deficit as a Percentage of GDP														
CBO's estimate of the President's budget	-2.6	-2.8	-2.4	-1.6	-1.3	-1.0	-1.2	-0.9	-1.1	-1.0	-1.0	-1.2	-1.5	-1.2
CBO's baseline	-2.6	-2.6	-1.9	-1.7	-1.5	-1.3	-0.7	0.3	0.3	0.4	0.5	0.3	-1.4	-0.4
Debt Held by the Public as a Percentage of GDP														
CBO's estimate of the President's budget	37.4	38.0	38.5	38.3	37.8	37.1	36.7	36.1	35.7	35.2	34.8	34.5	n.a.	n.a.
CBO's baseline	37.4	37.7	37.8	37.7	37.4	37.0	36.2	34.3	32.6	30.9	29.1	27.6	n.a.	n.a.

Source: Congressional Budget Office.

Note: GDP = gross domestic product; n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

b. Negative numbers indicate an increase in the deficit or a decrease in the surplus.

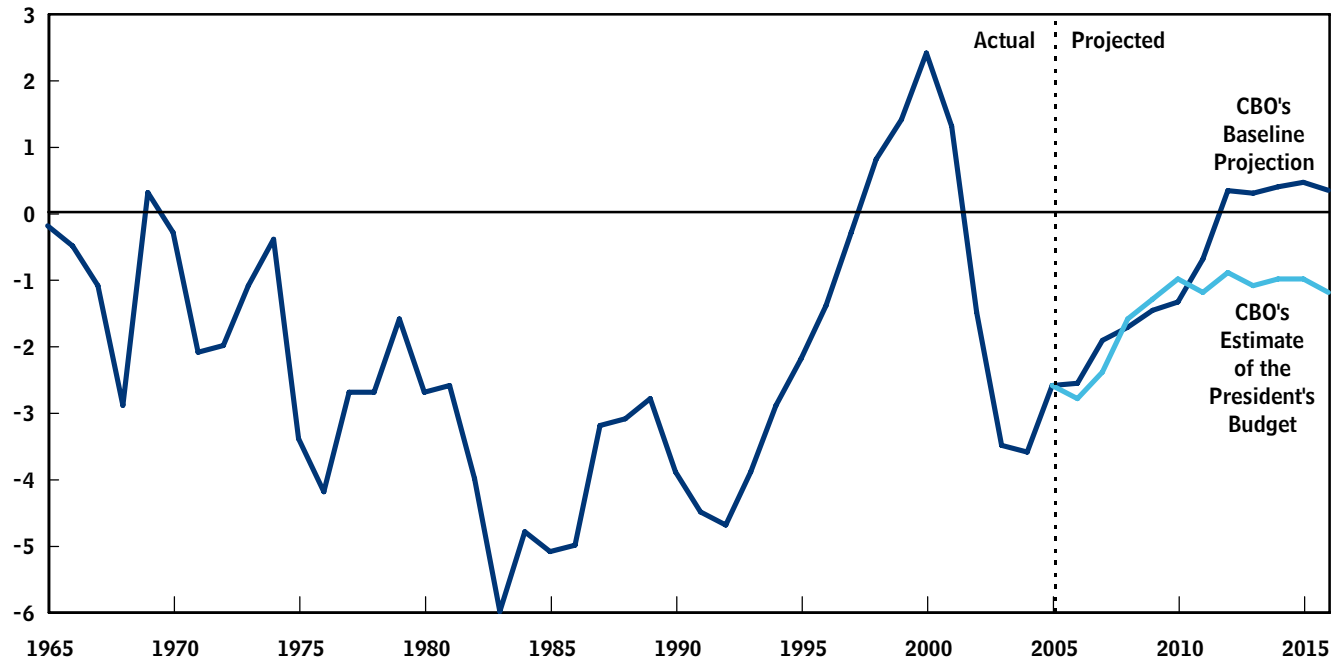
19 percent of GDP for most of the next 10 years, CBO estimates (see Table 1-2). Mandatory spending programs would grow faster than nominal GDP through 2016: at an average rate of 6.1 percent a year, versus 4.8 percent for nominal GDP. By contrast, discretionary outlays would be lower in 2011 than estimated for 2007 in dollar

terms; as a percentage of GDP, they would fall from 7.5 percent in 2007 to 5.9 percent in 2011.

Revenues would rise under the President's budget from 17.6 percent of GDP this year and next year to 18.2 percent by 2016. At that point, revenues would equal their average share of GDP since 1965.

Figure 1-1.**The Total Deficit or Surplus, 1965 to 2016**

(Percentage of gross domestic product)



Source: Congressional Budget Office.

The Impact of the President's Proposals on the Current Budget Outlook

The President's policies would increase the cumulative deficit over the next five years by \$61 billion relative to current laws and policies, as projected in CBO's latest baseline. CBO's baseline projections are required by law to incorporate the assumption that present laws and policies remain unchanged. Specifically, the baseline assumes that various tax provisions expire as scheduled and that all discretionary funding for the current year (including supplemental appropriations) grows at the rate of inflation in future years.

Over the 2007-2011 period, outlays would be \$221 billion lower under the President's proposals than under current law, CBO estimates (see Table 1-3). Those proposals would reduce mandatory spending by \$28 billion, defense outlays by \$33 billion, and nondefense discretionary outlays by \$170 billion, and increase net interest spending by \$10 billion, from the amounts in the baseline. At the same time, proposed changes to tax laws—such as extending the expiring provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001

(EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)—would reduce revenues by an estimated \$282 billion through 2011 compared with the baseline.³

The impact of the President's proposals on the cumulative deficit would be far greater over 10 years (\$1.4 trillion) than over five years (\$61 billion). Under the assumptions of the baseline, deficits would be followed by small surpluses beginning in 2012, CBO projects; under the President's policies, by contrast, deficits would continue throughout the 2007-2016 period. Mainly because of proposals to extend tax provisions that are scheduled to expire by 2011, total revenues during the 2007-2016 period would be \$1.7 trillion lower under the President's budget than in the baseline. Over those 10 years, the President's proposals would increase mandatory spending

3. For proposals that would amend the Internal Revenue Code, CBO is required by law to use estimates provided by the Joint Committee on Taxation. This analysis uses JCT's preliminary projections; JCT may revise some of those projections when it publishes final estimates. (At the time this report was written, the release date of those final estimates was not known.)

Table 1-2.**CBO's Estimate of the President's Budget for 2007**

(Billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007- 2011	Total, 2007- 2016
In Billions of Dollars														
Revenues														
On-budget	1,576	1,696	1,789	1,908	2,000	2,104	2,182	2,294	2,415	2,544	2,680	2,826	9,984	22,744
Off-budget	577	608	642	676	712	747	782	817	853	890	928	968	3,559	8,014
Total	2,154	2,304	2,431	2,585	2,712	2,852	2,964	3,111	3,268	3,434	3,608	3,794	13,543	30,758
Outlays														
Mandatory spending	1,320	1,431	1,485	1,561	1,643	1,742	1,877	1,961	2,119	2,253	2,396	2,587	8,308	19,624
Discretionary spending	968	1,025	1,034	995	987	988	993	1,001	1,027	1,050	1,074	1,104	4,998	10,253
Net interest	184	219	246	265	276	287	297	307	317	329	341	353	1,370	3,017
Total	2,472	2,675	2,766	2,820	2,906	3,017	3,167	3,270	3,463	3,631	3,812	4,044	14,676	32,895
On-budget	2,070	2,247	2,316	2,357	2,422	2,515	2,629	2,684	2,829	2,956	3,092	3,276	12,239	27,076
Off-budget	402	428	450	464	483	502	538	586	634	675	720	768	2,437	5,819
Deficit (-) or Surplus	-318	-371	-335	-236	-194	-165	-204	-158	-195	-197	-204	-250	-1,133	-2,137
On-budget	-493	-551	-527	-448	-422	-410	-447	-389	-414	-412	-412	-450	-2,255	-4,332
Off-budget	175	180	192	213	228	245	244	231	218	214	208	200	1,123	2,195
Debt Held by the Public	4,592	4,966	5,311	5,560	5,766	5,943	6,158	6,326	6,528	6,733	6,942	7,195	n.a.	n.a.
Memorandum:														
Gross Domestic Product	12,293	13,082	13,781	14,508	15,264	16,021	16,768	17,524	18,311	19,121	19,963	20,839	76,343	172,101
As a Percentage of Gross Domestic Product														
Revenues														
On-budget	12.8	13.0	13.0	13.2	13.1	13.1	13.0	13.1	13.2	13.3	13.4	13.6	13.1	13.2
Off-budget	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.6	4.6	4.7	4.7
Total	17.5	17.6	17.6	17.8	17.8	17.8	17.7	17.8	17.8	18.0	18.1	18.2	17.7	17.9
Outlays														
Mandatory spending	10.7	10.9	10.8	10.8	10.8	10.9	11.2	11.2	11.6	11.8	12.0	12.4	10.9	11.4
Discretionary spending	7.9	7.8	7.5	6.9	6.5	6.2	5.9	5.7	5.6	5.5	5.4	5.3	6.5	6.0
Net interest	1.5	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.7	1.7	1.7	1.7	1.8	1.8
Total	20.1	20.4	20.1	19.4	19.0	18.8	18.9	18.7	18.9	19.0	19.1	19.4	19.2	19.1
On-budget	16.8	17.2	16.8	16.2	15.9	15.7	15.7	15.3	15.4	15.5	15.5	15.7	16.0	15.7
Off-budget	3.3	3.3	3.3	3.2	3.2	3.1	3.2	3.3	3.5	3.5	3.6	3.7	3.2	3.4
Deficit (-) or Surplus	-2.6	-2.8	-2.4	-1.6	-1.3	-1.0	-1.2	-0.9	-1.1	-1.0	-1.0	-1.2	-1.5	-1.2
On-budget	-4.0	-4.2	-3.8	-3.1	-2.8	-2.6	-2.7	-2.2	-2.3	-2.2	-2.1	-2.2	-3.0	-2.5
Off-budget	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.3	1.2	1.1	1.0	1.0	1.5	1.3
Debt Held by the Public	37.4	38.0	38.5	38.3	37.8	37.1	36.7	36.1	35.7	35.2	34.8	34.5	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

Table 1-3.

CBO's Estimate of the Effect of the President's Budget on Baseline Deficits or Surpluses

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007- 2011	Total, 2007- 2016
Total Deficit (-) or Surplus as Projected in CBO's March 2006 Baseline	-336	-265	-250	-224	-216	-117	58	53	74	91	70	-1,072	-726
Effect of the President's Proposals													
Revenues													
Extension of expiring EGTRRA and JGTRRA provisions													
General tax rates, child tax credit, and tax brackets	0	0	0	0	0	-94	-154	-159	-162	-166	-172	-94	-906
Estate and gift taxes	*	-1	-2	-1	-2	-30	-56	-60	-67	-73	-79	-35	-369
Tax rates on dividends and capital gains	0	0	-2	-12	-9	-24	-26	-28	-30	-31	-33	-48	-197
Expensing for small businesses	0	0	-3	-6	-4	-3	-2	-1	-1	-1	-1	-16	-23
Education, retirement, and other provisions	0	0	0	0	0	-4	-7	-8	-9	-10	-11	-4	-50
Subtotal, proposed extensions	*	-1	-7	-19	-14	-155	-245	-257	-269	-282	-296	-197	-1,545
AMT extension	-6	-26	0	0	0	0	0	0	0	0	0	-26	-26
Research and experimentation tax credit	-2	-4	-6	-7	-8	-8	-9	-9	-10	-10	-10	-32	-80
Expansion of expensing for small businesses	0	-1	-3	-2	-1	-1	-1	-1	-1	-1	-1	-9	-12
Expansion of health savings accounts	0	*	-1	-1	-2	-2	-2	-2	-2	-2	-3	-5	-16
Deduction for high-deductible health insurance	0	*	-1	-3	-4	-4	-4	-3	-3	-2	-1	-11	-24
Refundable health insurance tax credit	0	*	*	-1	-1	-1	-1	-1	-1	-1	-1	-4	-10
Expansion of tax-free savings accounts	0	3	5	4	3	*	-1	-2	-3	-4	-5	15	*
Other proposals	*	*	-1	-3	-4	-5	-4	-4	-3	-4	-4	-12	-30
Total Effect on Revenues	-9	-30	-14	-31	-32	-175	-267	-279	-291	-305	-320	-282	-1,744
Outlays													
Mandatory													
Social Security individual accounts	0	0	0	1	1	18	38	55	61	66	72	19	312
Medicare	0	-3	-5	-8	-9	-12	-12	-15	-19	-24	-31	-37	-138
Earned income and child tax credits	0	*	*	*	*	*	15	16	16	16	16	-1	77
Pension insurance	0	0	-4	-4	-4	-4	-4	-4	-4	-4	-4	-14	-35
Refundable tax credits from health care proposals	0	*	1	1	2	2	2	3	3	3	4	6	21
Medicaid	0	-1	-1	-1	-1	-1	-1	-1	-1	-2	-2	-5	-11
Other proposals	3	5	1	-2	*	*	*	*	1	-2	-3	4	1
Subtotal, mandatory	3	1	-8	-12	-11	2	40	54	56	53	52	-28	226
Discretionary													
Defense	22	35	-6	-16	-21	-25	-26	-27	-28	-28	-29	-33	-171
Nondefense	1	*	-17	-35	-50	-68	-74	-77	-80	-82	-84	-170	-567
Subtotal, discretionary	23	35	-23	-52	-71	-93	-100	-104	-107	-110	-113	-203	-738
Net interest	1	3	3	2	*	1	9	20	33	46	61	10	179
Total Effect on Outlays	27	40	-28	-62	-82	-89	-51	-30	-19	-11	*	-221	-333
Total Impact on the Deficit or Surplus^a	-35	-70	15	31	50	-86	-216	-249	-272	-294	-320	-61	-1,411
Total Deficit Under the President's Proposals	-371	-335	-236	-194	-165	-204	-158	-195	-197	-204	-250	-1,133	-2,137

Sources: Congressional Budget Office; Joint Committee on Taxation.

Note: * = between -\$500 million and \$500 million; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; AMT = alternative minimum tax.

a. Negative numbers indicate an increase in the deficit or a decrease in the surplus.

by a total of \$226 billion from baseline levels but would decrease discretionary spending by \$738 billion. The higher deficits that would result under the President's budget would require additional federal borrowing; debt-service costs on that borrowing would add another \$179 billion to the cumulative deficit between 2007 and 2016.

The Impact on the Economy

The estimates in this chapter result from an analysis of the President's budgetary proposals that does not account for the proposals' potential impact on the economy. Such an economic impact, however, could influence how the policy changes would affect spending and revenues. Therefore, CBO has also prepared a macroeconomic analysis of the President's budget, which is described in Chapter 2. That assessment uses various models to indicate the range of possible economic and budgetary effects of the President's proposals.

CBO has concluded that the macroeconomic effects—and their resulting budgetary impact—would most likely be modest over the next five years. During the following five years, the effects would be somewhat larger and would generally increase economic output.

Comparison with the Administration's Estimates

CBO's estimate of how the President's budget would affect the deficit differs noticeably from the Administration's estimate for 2006. However, the two sets of estimates are similar for each year of the 2007-2011 period. (The Administration did not provide budget estimates beyond 2011.)

CBO projects a deficit of \$371 billion in 2006 under the President's budget, whereas the Administration expects a shortfall of \$423 billion (see Table 1-4). For 2007, CBO estimates that the deficit would total \$335 billion under the President's proposals, \$20 billion less than the Administration's estimate of \$354 billion. Both CBO and the Administration expect the deficit to shrink each year through 2010. For the 2007-2011 period, CBO's cumulative deficit projection of \$1.1 trillion is only \$40 billion less than the Administration's projection.

Overall, CBO's estimates of outlays under the President's budget are smaller than those of the Administration—by \$34 billion for 2006 and by a total of \$130 billion (or 0.9 percent) for the 2007-2011 period. Almost half of the difference over five years (about \$63 billion) stems from different estimates of the President's proposal to add vol-

untary individual accounts to the Social Security program starting in 2010. Differing economic assumptions cause CBO's baseline projections of mandatory outlays between 2007 and 2011 to be lower than the Administration's by another \$31 billion. In addition, CBO projects that net interest payments over that period would be about \$69 billion lower than the Administration's estimate. (Most of that gap comes from differing assumptions about future interest rates and lower projected deficits.) Partially offsetting those lower estimates, CBO's calculation of discretionary outlays under the President's budget during the 2007-2011 period exceeds the Administration's by \$37 billion, mostly because of differing estimates of defense outlays.

CBO's and the Administration's projections of revenues under the President's budget are generally similar. CBO's revenue estimates are \$19 billion higher than the Administration's for 2006 but \$90 billion (or 0.7 percent) lower than the Administration's for the 2007-2011 period. Those differences mainly result from differing estimates of revenues under current law.

CBO's Most Recent Baseline Budget Projections

In conjunction with its analysis of the President's budget, CBO typically updates its baseline projections to account for new information from the budget submission and other sources. (CBO refers to such changes as technical revisions.) The update also incorporates the effects of legislation enacted in the two months since the previous baseline was completed.⁴ (CBO typically updates its economic assumptions during the summer.)

In this case, most of the changes to CBO's baseline since January result from enactment of the Deficit Reduction Act of 2005 (Public Law 109-171). As a whole, new laws have lowered total outlay projections for the 2007-2016 period by \$124 billion. Reductions in mandatory spending stemming from the Deficit Reduction Act account for \$106 billion of that total.⁵

4. For the previous baseline, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (January 2006).

5. CBO estimates that the Deficit Reduction Act will reduce mandatory spending by \$39 billion between 2006 and 2010, the period covered by the budget resolution for 2006. For more details, see Congressional Budget Office, *Cost Estimate for S. 1932, the Deficit Reduction Act of 2005* (January 27, 2006).

Table 1-4.

Sources of Differences Between CBO's and the Administration's Estimates of the President's Budget

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	Total, 2007- 2011
Administration's Estimate							
Deficit Under the President's Proposals	-423	-354	-223	-208	-183	-205	-1,173
Sources of Differences Between CBO and the Administration							
Revenue Differences							
Economic	-15	-26	-35	-41	-47	-65	-213
Technical	34	41	29	39	21	-7	123
Total Revenue Differences	19	15	-6	-2	-26	-71	-90
Outlay Differences							
Mandatory							
Economic	*	-2	-4	-7	-8	-11	-31
Technical							
Social Security individual accounts	0	*	*	*	-23	-40	-63
Other	-25	-7	4	-6	2	4	-4
Subtotal, technical	-25	-7	3	-6	-21	-36	-67
Subtotal, mandatory	-25	-9	-1	-12	-29	-47	-98
Discretionary (Technical)	-7	6	15	12	5	-1	37
Net interest							
Economic	-1	3	*	-4	-6	-8	-15
Technical	-1	-4	-8	-11	-14	-17	-54
Subtotal, net interest	-1	-1	-8	-15	-20	-25	-69
Total Outlay Differences	-34	-4	7	-16	-44	-73	-130
All Differences^a	52	20	-12	14	18	1	40
CBO's Estimate							
Deficit Under the President's Proposals	-371	-335	-236	-194	-165	-204	-1,133
Memorandum:							
Total Economic Differences ^a	-15	-26	-31	-30	-33	-46	-166
Total Technical Differences ^a	67	46	18	44	51	47	206

Sources: Congressional Budget Office; Joint Committee on Taxation.

Note: * = between -\$500 million and \$500 million.

a. Positive numbers denote that such differences cause CBO's estimate of the deficit to be lower than the Administration's estimate.

Technical changes to CBO's baseline have increased projected outlays and revenues slightly—by \$24 billion and \$6 billion, respectively—over 10 years. The largest technical change involves the Medicare program. CBO has raised its estimate of Medicare outlays over the 2007-2016 period by \$102 billion because of recent rapid growth in spending for that program. In the other direction, CBO has trimmed its estimate of spending for the Medicaid program by \$63 billion over that period, primarily because of slower-than-expected growth in per capita spending in several areas, such as long-term care services and prescription drugs.

As a result of the various changes to its baseline, CBO now projects that if current tax and spending policies remained the same, the cumulative deficit for the 2007-2016 period would total \$726 billion. That figure is \$106 billion smaller than CBO estimated in January. (For more information about recent revisions to CBO's baseline, see Appendix A.)

Policy Proposals That Affect Revenues

The President's budget proposes several changes to tax law that would reduce revenues significantly over the next decade from the amounts that CBO estimates would be collected under current law. Those proposals include the extension of a number of expiring tax provisions and a variety of new tax incentives. The most significant changes involve provisions of EGTRRA and JGTRRA, the alternative minimum tax (AMT), the research and experimentation tax credit, tax deductions for certain premiums paid for health care plans with high deductibles, and various types of savings accounts.

CBO and JCT estimate that as a whole, the President's proposals would reduce revenues by \$9 billion this year, \$30 billion in 2007, and \$1.7 trillion over the 2007-2016 period (see Table 1-3 on page 5).⁶ The effect of those proposals on refundable tax credits would also increase mandatory outlays by \$98 billion through 2016.⁷

Permanent Extensions of Provisions in EGTRRA and JGTRRA

The Administration proposes to make permanent various provisions of EGTRRA and JGTRRA that are set to expire at the end of 2010. Those provisions include changes in income tax rates, relief from the so-called marriage penalty, an increase in the child tax credit, provisions related to education, and repeal of the estate tax. (The provisions were enacted in EGTRRA; implementation of some of them was accelerated by JGTRRA.) Extending those provisions rather than letting them expire as scheduled would reduce revenues by \$1.3 trillion and increase outlays by \$81 billion through 2016, according to CBO's and JCT's projections.

The President also proposes to make permanent the current tax rates on capital gains and dividends, which are scheduled under JGTRRA to rise at the end of 2008. That policy change would reduce revenues by an additional \$197 billion between 2009 and 2016.

Another provision of JGTRRA and the American Jobs Creation Act of 2004 altered the rules governing depreciation for small businesses from 2003 through 2007. It increased the amount of investment that such businesses could expense (that is, deduct from their taxable income immediately rather than over time) from \$25,000 to \$100,000. One proposal in the President's budget would make the \$100,000 limit permanent and index it for inflation, which would decrease revenues by about \$23 billion over the 2007-2016 period.

In all, the proposals in the 2007 budget to permanently extend various tax provisions of EGTRRA and JGTRRA would reduce revenues by an estimated \$1.5 trillion through 2016. They would also increase outlays for refundable tax credits by \$81 billion over that period.

Changes to the Alternative Minimum Tax

EGTRRA, JGTRRA, and the Working Families Tax Relief Act of 2005 expanded the amount of income that is exempt from the alternative minimum tax through

6. As noted above, CBO is required by law to use estimates from the Joint Committee on Taxation for proposals that would amend the Internal Revenue Code.

7. A tax credit is refundable if, when the allowable credit exceeds the amount of tax owed, the difference is paid to the taxpayer as a refund. Such refunds are recorded in the budget as outlays.

2005.⁸ Those exemption amounts reverted to pre-EGTRRA levels at the beginning of calendar year 2006, which will cause many more people to be liable for tax under the AMT. In addition, under current law, the AMT will restrict the use of some nonrefundable personal tax credits—such as the higher education credits and the child and dependent care credit—this year.

The President's budget proposes to continue both the AMT's unrestricted use of those personal tax credits and the higher AMT exemption levels for one year (through 2006). CBO and JCT assume that the provision would be enacted early enough to allow taxpayers to reduce their payments of estimated taxes in 2006, in which case it would lower federal revenues by \$6 billion this year. That proposal would also decrease revenues by \$26 billion and increase outlays for refundable tax credits by about \$0.2 billion in 2007.

Extension of the Research and Experimentation Tax Credit

Under current law, corporations can obtain a tax credit of 20 percent on certain research expenditures above a base amount. That credit expired on December 31, 2005, but the President's budget proposes to make it permanent. That proposal would reduce projected revenues by a total of \$80 billion over the next 10 years, according to CBO and JCT.

Expansion of Expensing for Small Businesses

The President's budget proposes not only to make permanent the current \$100,000 limit on the amount of investment that small businesses can expense but also to raise that limit to \$200,000 and include off-the-shelf computer equipment as qualified investments. Those additional changes would decrease revenues by \$12 billion over 10 years.

Health-Related Tax Changes

The President's budget contains several proposals designed to encourage the use of health insurance plans with high deductibles. Those proposals include expand-

ing health savings accounts (HSAs) and adding new tax deductions and credits for the cost of HSA-eligible insurance plans.

Expansion of Health Savings Accounts. Currently, people can use health savings accounts to accumulate funds on a tax-preferred basis to pay for medical expenses if those expenses are covered only by an HSA-qualified high-deductible health plan. Under the President's proposal, people who made after-tax contributions to an HSA would be able to take an income tax credit of up to 15.3 percent of their HSA contributions so as to offset any payroll taxes they paid. However, most nonmedical withdrawals from an HSA would be subject to an additional tax of 30 percent (designed in part to recapture the tax credit for payroll taxes) in order to discourage the use of HSAs for anything other than medical expenses. The President's HSA proposal would make other changes as well:

- Increasing the maximum amount that people are allowed to contribute to HSAs from the amount of their health plan's deductible to their maximum out-of-pocket expenses;
- Allowing HSA funds to be used tax-free to pay premiums for nongroup high-deductible health insurance; and
- Allowing taxpayers to make higher contributions to HSAs in certain other cases.

If those changes took effect on January 1, 2007, as proposed, they would reduce revenues by an estimated \$16 billion and increase outlays by \$0.4 billion over the 2007-2016 period.

"Above-the-Line" Tax Deduction for High-Deductible

Health Insurance. In most cases, income used to pay premiums for employment-based health insurance is not taxed, whereas income that individuals use to pay premiums for non-employment-based health insurance is taxed, whether the policy has a low or a high deductible. As noted above, people who buy certain individual health plans with a high deductible can contribute to HSAs, which can be used to pay their and their dependents' out-of-pocket health care costs.

The President's budget proposes allowing people who contribute to HSAs to deduct the premiums they pay for

8. The AMT is a tax that limits the extent to which higher-income taxpayers can reduce the amount they owe by using preferences in the tax code. People subject to the AMT are required to recalculate their tax liability on the basis of a more limited set of exemptions, deductions, and tax credits than would normally apply. The amount by which a taxpayer's AMT calculation exceeds his or her regular tax calculation is that taxpayer's AMT liability.

individual high-deductible health plans from their taxable income. The deduction would occur “above the line”—in other words, it would be subtracted from income to calculate adjusted gross income (AGI) on tax returns. As a result, it would be allowed even if taxpayers did not itemize deductions. (Currently, taxpayers who itemize can deduct medical expenses that exceed 7.5 percent of AGI from their taxable income.)

If that proposal took effect on January 1, 2007, it would lower revenues by an estimated \$24 billion through 2016. In addition, by increasing eligibility for the proposed income tax credit for HSA contributions, it would increase the amount of refundable HSA credits paid and thus raise outlays by \$9 billion over the 2007-2016 period.

Refundable Tax Credit for High-Deductible Health Insurance. The President also proposes to establish a refundable income tax credit for lower-income people for the cost of high-deductible health insurance. The credit would be worth as much as \$1,000 per adult and \$500 per child (for up to two children). It could cover up to 90 percent of the cost of insurance for single taxpayers with a maximum modified AGI of \$15,000; those with higher income would receive less, and the credit would phase out completely for single taxpayers with a modified AGI of \$30,000. (The maximum AGI would be higher for families.) If that credit took effect on January 1, 2007, it would reduce revenues by \$10 billion and raise outlays by \$11 billion over the 2007-2016 period, CBO and JCT estimate.

Expansion of Tax-Free Savings Accounts

The tax code provides for a variety of tax-favored savings plans. Those plans are used primarily for retirement but also for other purposes, such as education. The President proposes to unify many of those plans into two tax-favored vehicles for saving—retirement savings accounts (RSAs) and lifetime savings accounts (LSAs)—and to expand their scope.

Individuals would be allowed to contribute up to \$5,000 a year to an RSA, with no income limits on participation. Those contributions would not be tax-deductible, but all earnings on the account would accumulate tax-free. Account holders could withdraw funds without facing taxes or penalties after they turned 58 years old or became disabled. (When an account holder died, his or her heirs could also make tax- and penalty-free withdrawals.)

Accounts that are now held as Roth individual retirement accounts (IRAs) would automatically become RSAs under the President's plan. In addition, traditional IRAs could be converted into RSAs in the same way that they can now be converted into Roth IRAs. No further contributions to traditional IRAs would be allowed.

Lifetime savings accounts would have the same contribution limits, tax treatment, and lack of income restrictions as RSAs. (Individuals could contribute to both types of accounts in the same year.) Unlike with RSAs, however, holders of LSAs could make withdrawals at any age and for any purpose. Balances now held in Coverdell education savings accounts and qualified state tuition plans could be moved into LSAs.

On net, those proposals would reduce revenues by \$0.3 billion over the 2007-2016 period. CBO and JCT project a net increase in revenues during the first half of that period as new contributions were directed away from current savings plans, which receive an immediate tax deduction, and toward the new plans, which would not. In addition, some taxpayers would convert their traditional IRAs to RSAs, generating more revenue in the early years. By the second half of the projection period, however, the proposals would result in a net reduction in revenues as the effect of untaxed withdrawals began to outweigh the effect of new contributions.

Other Revenue Proposals

The President's budget proposes a number of other tax changes, such as incentives related to charitable giving, health care, and education. It would also make various changes in tax law related to pensions and other retirement saving and extend some provisions that expired at the end of 2005. Together, those proposals would reduce revenues by \$30 billion between 2007 and 2016 and decrease outlays for refundable tax credits by \$3 billion over the same period.

Policy Proposals That Affect Mandatory Spending

If the proposals in the President's budget were enacted, they would produce a net reduction in mandatory spending of \$28 billion over the next five years, CBO estimates, but a net increase of \$226 billion over the full 2007-2016 period (see Table 1-3 on page 5). Outlays would rise for the Social Security program (for the proposed individual accounts) and for refundable tax credits

(including the earned income and child tax credits as well as refundable credits for health care expenses). Those increases would be partly offset by lower spending for Medicare and Medicaid and by higher premium payments from individuals for Medicare and from corporations for pension insurance.

Social Security

The President's budget proposes establishing voluntary individual accounts for workers that would partially replace their future defined Social Security benefits. For people who chose to participate, the government would deposit an amount equivalent to up to 4 percentage points of the current 12.4 percent tax on covered earnings into an individual account. The money in the account would be invested at the direction of the account holder, with a limited number of investment options similar to those available under the Thrift Savings Plan for federal employees. When account holders eventually began to draw Social Security benefits, their defined benefit would be reduced according to a formula based on the amount deposited in their account.

CBO estimates that net outlays from establishing individual accounts would total \$312 billion over the 2009-2016 period. (For more details, see Box 1-1.) The Administration projects much higher outlays—\$712 billion over that period—chiefly because it estimates that two-thirds of eligible workers would participate, whereas CBO estimates that about one-third would sign up.

The President's budget also includes four proposals that would modestly reduce outlays for Social Security benefits:

- Suspending benefits for 16- and 17-year-old children of retired, deceased, or disabled workers unless the children are in school (under current law, such benefits essentially continue through age 18, or for a slightly longer period if the recipients are still in secondary school);
- Requiring state and local governments to provide information about their annuitants in order to strengthen enforcement of two current provisions (the windfall elimination provision and the government pension offset) that reduce Social Security benefits for people who have pensions from employment that was not covered by Social Security;

- Altering the way disability benefits are reduced when beneficiaries also receive workers' compensation for a work-related illness or injury; and
- Ending the lump-sum death benefit, a one-time payment of \$255 that goes to about 800,000 people per year.

In all, those four proposals would save \$6 billion over the 2007-2016 period, CBO estimates. (Those savings are included under other mandatory outlay proposals in Table 1-3 on page 5.)

Medicare

The budget contains various proposals to alter the Medicare program; together, they would reduce spending by \$138 billion through 2016, CBO estimates. About one-third of those savings would result from holding increases in payment rates for many services below the rate of inflation from 2007 through 2009. Those payment-rate provisions would affect Medicare services furnished by hospitals, skilled nursing facilities, home health agencies, hospices, and ambulance providers, among others.

Another one-third of the estimated savings come from two proposals that would have relatively little impact on Medicare spending over the next five years but a sharply rising effect thereafter. One provision involves the income thresholds that determine income-related premiums for Part B of Medicare (supplementary medical insurance). The President proposes to eliminate the scheduled indexing of those thresholds for inflation, which would increase receipts from premium payments and thus reduce net outlays. That provision would affect a growing number of people over time as nominal incomes rose. The other provision would impose across-the-board cuts in payment rates when more than 45 percent of Medicare spending was funded from general revenues—which CBO estimates will occur beginning in 2011.

Most of the remaining estimated savings stems from two other proposals. One would shorten the period of time that Medicare would pay to rent oxygen equipment for beneficiaries before transferring ownership of the equipment to the beneficiary. The other would eliminate payments to health care providers for bad debt (for deductibles and cost sharing owed by Medicare beneficiaries).

Box 1-1.**The President's Proposal for Individual Social Security Accounts**

The Old-Age, Survivors, and Disability Insurance programs—popularly known as Social Security—are financed through a tax of 12.4 percent on earnings (up to a statutory limit) from jobs covered by Social Security. The President's budget proposes giving workers the option to transfer up to 4 percentage points of that tax into individual investment accounts, beginning in 2010.¹ The amount that could be transferred into an account would be capped at \$1,100 in 2010. In subsequent years, the cap would increase through two mechanisms: \$100 would be added to it each year (through 2016), and the sum would be adjusted upward at the same rate as average wages (see the table at right). The dollar cap would keep contributions below the full 4 percentage points for most workers.

In the first year of the individual-account program, only workers born between 1950 and 1965 (ages 45 through 60) would be eligible to participate. Eligibility would expand in 2011 to include workers born between 1950 and 1978 (ages 33 through 61). After 2011, any worker born in 1950 or later could take part. As in the federal employees' Thrift Savings Plan, participants could pick from a limited selection of investments for their account balances.

When account holders eventually began to draw Social Security benefits, their benefits would be reduced according to a formula based on the sums deposited in their account. The reduction (or offset) would equal the amount of annuity payments that would result if the deposited sums earned an annual return of 3.0 percent after inflation, minus 30 basis points

(0.3 percentage points) for administrative expenses, for a total real return of 2.7 percent per year. Exact distribution rules—notably, whether some or all of an account would have to be converted into an annuity—are unclear. If a married account holder died before retirement, the balance would go into his or her spouse's account; balances of unmarried account holders would go to their heirs.

Participation in the accounts would be optional, so a key factor in estimating their budgetary impact is determining how many workers would be likely to participate. The Congressional Budget Office (CBO) estimates that one-third of eligible workers would sign up—lower than the two-thirds estimated in the President's budget. CBO bases that judgment on several key features of the proposal:

- The proposed offset rules and the initially modest size of the accounts limit the potential advantages of participation.
- Workers would have to opt in (elect to participate). Recent research on 401(k) and similar plans has shown that opt-in plans tend to have significantly lower participation rates than opt-out plans (in which workers are automatically enrolled and then have the opportunity to cease participating).
- Once enrolled, workers would not be able to change their minds; as a result, many people might adopt a "wait and see" attitude to the accounts.
- More people might sign up if traditional Social Security benefits were reduced significantly, which could make the accounts more attractive, but no specific changes of that type are proposed in the President's budget.

1. The details of the President's proposal described here come mainly from a memorandum from Stephen C. Goss, Chief Actuary of the Social Security Administration, to Charles P. Blahous, Special Assistant to the President for Economic Policy, February 6, 2006.

Box 1-1.**Continued****Estimated Budgetary Effect of the Administration's Proposal for Individual Social Security Accounts**

(Billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2009- 2016
Transfers to Individual Accounts									
Contributions	0	0	17	36	52	57	63	69	293
Interest	0	0	1	2	3	3	3	4	15
Savings from Social Security Benefit Reductions	0	0	0	*	*	*	*	-1	-1
Administrative Costs ^a	1	1	*	1	1	1	1	*	4
Net Outlays	1	1	18	38	55	61	66	72	312
Memorandum:									
Administration's Estimate of Net Outlays	0	24	57	96	115	127	140	153	712
CBO's Estimate of Payments to Interim Fund	0	12	31	48	56	62	67	73	349
Maximum Contribution (In dollars, by calendar year)									
2010 dollars	0	1,100	1,200	1,300	1,400	1,500	1,600	1,700	9,800
Current dollars ^b	0	1,100	1,253	1,412	1,581	1,759	1,947	2,148	11,200

Source: Congressional Budget Office.

Note: * = between -\$500 million and \$500 million.

a. Includes startup costs in 2009 and 2010 and then payments as necessary to supplement the amounts raised by charging accounts 30 basis points annually.

b. Indexed after 2010 to growth in Social Security's average wage index, with a two-year lag.

Besides a lower rate of participation, CBO's estimate of the proposal reflects two other differences from the Administration's calculations. First, the portion of Social Security taxes allocated to individual accounts each year would probably not be credited to account holders immediately. Under the current system of annual wage-reporting, the Social Security Administration does not have enough information to post earnings and credit payments of Social Security taxes to individual workers until the year after those taxes are paid. CBO assumes that the government would temporarily record the total estimated contributions in an interim fund and eventually transfer the money to specific accounts with about one year's interest.

(Budgetary outlays would occur only when funds were transferred to those accounts.)

Second, CBO concludes that the government would incur administrative costs for the program—initially for startup tasks and then to supplement the 30-basis-point charge, which is unlikely to suffice in the first few years after the accounts are created.²

2. For a fuller discussion of some of those implementation issues, see Congressional Budget Office, *Analysis of H.R. 3304, Growing Real Ownership for Workers Act of 2005*, letter to the Honorable Max Baucus (September 13, 2005).

Refundable Tax Credits

The tax proposals involving refundable credits that were discussed above would add about \$98 billion to mandatory outlays over the 2007-2016 period, CBO and JCT estimate. The largest of those changes would be making the 2001 expansion of the child tax credit permanent.⁹ Continuation of that credit in its current form, combined with changes to tax brackets and tax rates that affect the earned income tax credit, would increase outlays by \$77 billion through 2016. In addition, the tax proposals to expand the use of HSAs and add new tax deductions and credits for the cost of HSA-eligible insurance plans would raise outlays by \$21 billion over the next 10 years.

Pension Insurance

The President proposes raising the variable-rate insurance premiums that some companies pay to the federal Pension Benefit Guaranty Corporation (PBGC) under its single-employer program if their plans are underfunded. PBGC's board of directors would be given the authority to alter the premium rate, which currently is set by statute at \$9 per \$1,000 of underfunding. The higher premiums would be used to offset PBGC's existing deficit as well as its anticipated deficits over the next 10 years. (Unlike the policies enacted as part of the Deficit Reduction Act, which increased flat-rate premiums and implemented a termination premium, this proposal would affect only variable-rate premiums.)

That change, and related pension-reform initiatives, would increase collections of variable-rate premiums nearly fivefold—by \$35 billion—over the 2008-2016 period from the amount that would be collected under current law, CBO estimates.¹⁰ Such an increase would almost triple PBGC's total premium receipts (including other types of premiums it collects) over that period. Those premium payments are recorded in the budget as offsets to outlays.

9. Before EGTRRA was enacted, the maximum child tax credit per qualifying child was \$500. The credit was refundable only for families with three or more qualifying children and had other limitations. EGTRRA increased the credit to \$1,000 per child, with refundability not contingent on the number of qualifying children but limited to 15 percent of the amount of earned income in excess of \$10,000 (indexed for inflation after 2001).

10. PBGC would also earn additional interest income as a result.

Medicaid

On net, the President's proposals for the Medicaid program would reduce federal spending by more than \$11 billion over the 2007-2016 period, CBO estimates. Proposals to cut spending on prescription drugs by reducing payment rates for multisource drugs and by allowing states to use closed formularies would save about \$7 billion during that period. Lowering the federal matching rate for some social services would save about \$4 billion, and cutting payments to states for administration would save another \$4 billion. Those savings would be partly offset by additional outlays of about \$4 billion for children's vaccines and for efforts to enroll more children in Medicaid and in the State Children's Health Insurance Program.

Other Mandatory Spending Proposals

The costs and savings of other proposals that involve mandatory spending programs would largely offset one another, resulting in about \$1 billion in additional outlays over the 2007-2016 period, CBO estimates. The effects of some of those proposals—notably, increasing funding for the flood insurance program—would be reflected in the federal budget almost immediately. Other proposals—such as extending customs user fees, which are recorded as offsets to mandatory spending—would not affect outlays until the last years of the projection period.

Flood Insurance. The President proposes to raise the borrowing limit for the National Flood Insurance Program by nearly \$6 billion to pay outstanding claims from Hurricanes Katrina, Rita, and Wilma. In recent months, the Congress and the President have raised that limit twice (by a cumulative \$17 billion), bringing the program's total available borrowing authority to \$18.5 billion.¹¹ The provision in the President's budget would increase the limit to \$24.1 billion, resulting in additional outlays of roughly \$3 billion in both 2006 and 2007, CBO estimates.

Agricultural Commodity Programs. The President's budget includes several proposals that would reduce spending for the Department of Agriculture's Commodity Credit Corporation by a total of \$6 billion over the next 10 years, CBO estimates. Those proposals include lowering

11. At the time this report was written, the Senate had passed legislation increasing the borrowing limit to \$21.2 billion; the House had passed a bill raising it to \$20.8 billion.

crop and dairy payments to farmers under all commodity programs by 5 percent, adjusting the price-support rates for dairy products to reduce the cost of purchases by the federal government, and tightening the limits on the maximum commodity payments that producers can receive.¹²

Customs User Fees. Under current law, customs user fees are scheduled to expire on September 30, 2014. The President has proposed extending those fees, which CBO estimates would increase offsetting receipts by \$6 billion through 2016.

Leasing in ANWR. The President also proposes leasing a portion of the coastal plain of the Arctic National Wildlife Refuge (ANWR) for oil and gas development. CBO anticipates that those leases would be offered in two phases (as specified in recent legislative proposals), with the first sale likely to occur in 2009 and the second in 2011. Proceeds to the federal government from bonuses and rents would total \$6 billion between 2009 and 2016, CBO estimates. (Although the federal government would later receive income from royalties on production, those payments would most likely begin after 2016.) Under the President's proposal, half of the receipts from leasing would be paid to Alaska, resulting in net federal receipts of \$3 billion over the projection period.

CBO's estimate of bonus bids is based on the U.S. Geological Survey's projections of the mean value of economically recoverable oil that could be produced from federal land in ANWR. It also relies on information from other federal agencies, the state of Alaska, and private sources about oil and gas companies' perceptions of key factors that affect the expected profitability of ANWR leases—in particular, companies' probable assumptions about long-term oil prices and required rates of return on such investments.

Other. Other policies proposed in the President's budget would affect mandatory spending in a number of areas. For example, over the next 10 years, the Administration would add about \$4 billion in spending for state grants

and demonstration projects aimed at ensuring health coverage for children and for people with chronic illnesses. Proposed spending for the Temporary Assistance for Needy Families (TANF) program would also rise by about \$4 billion over the 2007-2016 period, CBO estimates, through a combination of continuing an existing supplemental grant, adding a new one, and making TANF's contingency fund easier for states to access. In addition, the President's proposal to restructure existing tax benefits for New York City would effectively provide \$2 billion in grants to the city and state for improvements in transportation infrastructure.

Policy Proposals That Affect Discretionary Spending

So far, lawmakers have enacted \$901 billion in discretionary budget authority for 2006, including \$50 billion for military operations in Iraq and Afghanistan and a net \$9 billion in various supplemental appropriations. The Administration has requested another \$92 billion in supplemental funding for 2006 (\$72 billion for military operations in Iraq and Afghanistan and other purposes and \$20 billion for relief from hurricane damage). If that supplemental funding was enacted, total budget authority for 2006 would rise to \$993 billion.

The President's budget proposes \$925 billion in discretionary budget authority for 2007, CBO estimates—\$510 billion for defense and \$415 billion for nondefense programs (see Table 1-5). The defense request includes \$50 billion for operations in Iraq and Afghanistan.

With proposed and enacted supplemental appropriations and funding for Iraq and Afghanistan excluded, discretionary budget authority would grow by 3.6 percent, or \$30 billion, between 2006 and 2007 under the President's budget, CBO estimates. Defense funding would increase by about 6.4 percent, and appropriations for homeland security activities would rise by 6.6 percent. Funding for other nondefense activities would grow by 0.2 percent.

For 2008 through 2011, the President proposes increasing defense funding by an average of 2.8 percent per year (excluding possible appropriations for operations in Iraq and Afghanistan) and essentially holding nondefense funding constant, other than spending for homeland security.

12. The President also proposes to charge sugar processors and milk producers marketing assessments on all domestically produced sugar and milk. CBO considers the receipts from those assessments, which would total about \$900 million over the next 10 years, to be additional federal revenues rather than offsets to spending.

Table 1-5.**Proposed Changes in Discretionary Budget Authority in the President's Budget, 2005 to 2007**

(Billions of dollars)

	Actual 2005	Administration's Request		Percentage Change	
		2006	2007	2005-2006	2006-2007
Budget Authority					
Defense	500 ^a	558 ^b	510	11.7	-8.6
Nondefense					
Homeland security ^c	31	28 ^b	29	-9.3	6.2
Other	456	407 ^b	386	-10.8	-5.3
Subtotal, nondefense	487	435 ^b	415	-10.7	-4.6
Total	987	993 ^b	925	0.7	-6.8
Budget Authority Excluding Funding for Activities in Iraq and Afghanistan and Supplemental Appropriations ^d					
Defense	420	432	460	2.8	6.4
Nondefense					
Homeland security ^c	30	28	29	-8.2	6.6
Other	379	382	383	1.0	0.2
Subtotal, nondefense	409	410	413	0.3	0.7
Total	829	842	873	1.6	3.6

Source: Congressional Budget Office.

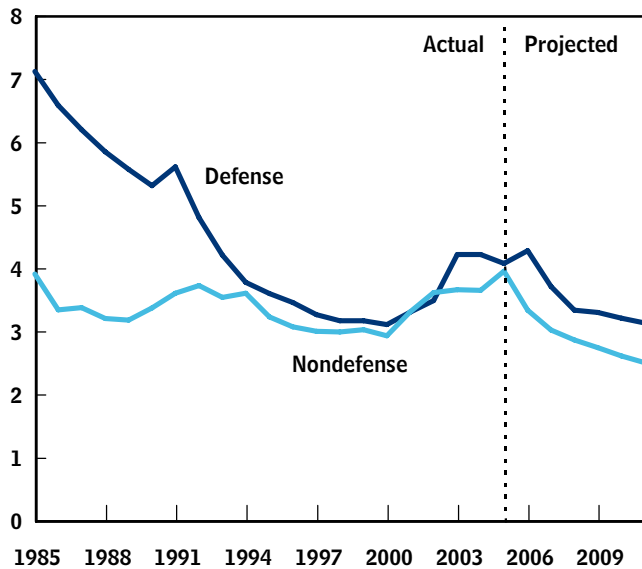
Note: Does not include obligation limitations for certain transportation programs.

- a. This amount does not include \$23 billion in balances that were still available in 2005 from \$26.8 billion in emergency funding that was provided at the end of 2004. That funding, which was largely for 2005 costs associated with military operations in Iraq and Afghanistan, was counted as budget authority in 2004 because it was made available in that year.
- b. Includes the Administration's request for supplemental appropriations to fund operations in Iraq and Afghanistan and for further hurricane relief and recovery. CBO assumes that very little of that funding will be classified as related to homeland security.
- c. CBO's classification of homeland security funding is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some of the department's activities (such as disaster relief) are not included in the Administration's definition of homeland security, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within that definition. About 60 percent of all spending considered to be for homeland security is for activities outside the Department of Homeland Security.
- d. In 2005, the Congress and the President provided \$82 billion in supplemental funding primarily for military operations in Iraq and Afghanistan, \$62 billion in supplemental appropriations in response to Hurricanes Katrina and Rita, and \$13 billion in other supplemental funding (mostly for disaster relief from hurricanes in 2004 and veterans' benefits). Thus far in 2006, about \$59 billion has been provided for operations in Iraq and Afghanistan and for supplemental appropriations, net of rescissions. For this year, the President's budget requests another \$72 billion in supplemental funding, mostly for military activities in Iraq and Afghanistan, as well as \$20 billion for hurricane relief and recovery. For 2007, the President is requesting \$50 billion in additional appropriations for activities in Iraq and Afghanistan. In addition, the budget requests \$2.3 billion for 2007 to prepare for a possible flu pandemic; since funding for such activities in 2006 (\$3.8 billion) was provided through supplemental appropriations, for consistency the 2007 request has been excluded here.

Figure 1-2.

Discretionary Budget Authority Under the President's Budget, 1985 to 2011

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Defense Programs

CBO estimates that the President's proposals would add \$22 billion to defense outlays in 2006 and \$35 billion in 2007 relative to the baseline (see Table 1-6). Most of those outlays stem from the request for another \$68 billion in budget authority in 2006 for military activities in Iraq and Afghanistan (in addition to the \$50 billion already appropriated for this year).¹³ If that \$68 billion and other requested emergency supplemental funding was appropriated, budget authority for defense would total \$558 billion this year—7 percent more than the \$523 billion provided for 2005.¹⁴ Defense outlays would reach 4.0 percent of GDP in 2006, up from 3.0 percent of GDP just six years ago.

13. The supplemental request for operations in Iraq and Afghanistan in 2006 includes \$4 billion in funding for nondefense programs. In addition, the supplemental request for hurricane relief includes nearly \$2 billion in funding for the Department of Defense.

14. The 2005 amount includes \$23 billion in budget authority provided for war-related activities in the Department of Defense Appropriations Act, 2005 (Public Law 108-287) that was made available upon enactment in August 2004 but was not obligated by the beginning of fiscal year 2005.

Budget authority provided through emergency appropriations for operations in Iraq and Afghanistan and the war on terrorism would total \$118 billion in 2006, compared with \$100 billion in 2005. Most of that growth would come from an increase of more than \$15 billion (or 27 percent) in funding for operations and maintenance. Emergency appropriations for procurement would also rise—by almost \$7 billion, or 36 percent. Those increases would be slightly offset by declines of \$3 billion in emergency appropriations for military personnel and \$1 billion for other military accounts. In total, emergency appropriations for Iraq, Afghanistan, and the war on terrorism would constitute 21 percent of budget authority for defense in 2006.

The President's budget includes a much smaller amount for those activities in 2007 (\$50 billion) and no appropriations thereafter. As a result, budget authority for defense would decline to 3.1 percent of GDP in 2011 under the President's budget, CBO estimates (see Figure 1-2). Outlays for defense would be a total of \$68 billion less than the amounts in CBO's baseline between 2008 and 2011. (In keeping with the rules that govern baseline projections, the baseline assumes that the \$50 billion already appropriated this year will continue in each subsequent year through 2016, with adjustments for inflation.)

With funding for Iraq and Afghanistan and other supplemental appropriations excluded, budget authority for defense grew by 2.8 percent, or \$12 billion, from 2005 to 2006. Under the President's budget, it would rise by 6.4 percent, or \$28 billion, in 2007.

All major categories of funding for the Department of Defense would receive increases in 2007. The largest percentage rise (57 percent, or \$5 billion) would be for military construction, to implement a new round of base closures. Other categories that would receive significant increases in 2007 would be operation and maintenance activities (7 percent, or \$9.7 billion) and procurement (10 percent, or \$8 billion). Appropriations for military personnel and for research and development would both grow by between 3 percent and 4 percent (by \$4 billion for personnel and by \$2 billion for research and development).

Nondefense Discretionary Programs

The President's budget includes an additional \$22 billion in supplemental nondefense appropriations for 2006, mostly for hurricane relief and recovery. For 2007

Table 1-6.**Discretionary Spending Under the President's Budget and in CBO's March Baseline**

(Billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007- 2011	Total, 2007- 2016
CBO's Estimate of Discretionary Spending Under the President's Budget^a														
Budget Authority														
Defense	500	558	510	482	502	512	523	536	549	563	577	591	2,530	5,345
Nondefense														
Homeland security ^b	31	28	29	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	456	407	386	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	487	435	415	414	417	417	418	428	437	447	457	468	2,080	4,317
Total	987	993	925	896	919	929	941	964	986	1,010	1,034	1,058	4,610	9,662
Outlays														
Defense	494	523	533	503	503	510	522	525	542	555	569	588	2,571	5,350
Nondefense														
Homeland security ^b	27	28	30	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	447	474	471	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	474	502	501	492	484	478	471	476	485	495	506	516	2,427	4,904
Total	968	1,025	1,034	995	987	988	993	1,001	1,027	1,050	1,074	1,104	4,998	10,253
CBO's March 2006 Baseline for Discretionary Spending														
Budget Authority														
Defense	500	488	501	512	525	537	550	563	577	591	605	620	2,625	5,580
Nondefense														
Homeland security ^b	31	28	28	29	32	30	31	32	33	34	35	36	151	319
Other	456	385	421	431	441	451	461	472	483	494	506	518	2,205	4,679
Subtotal, nondefense	487	413	449	459	472	481	492	504	516	528	541	553	2,355	4,998
Total	987	901	950	972	997	1,019	1,042	1,068	1,093	1,119	1,146	1,173	4,980	10,578
Outlays														
Defense	494	501	498	508	519	531	547	551	569	583	597	617	2,604	5,521
Nondefense														
Homeland security ^b	27	28	30	30	30	31	31	32	33	34	34	35	152	320
Other	447	472	471	479	489	498	507	518	529	541	553	565	2,445	5,150
Subtotal, nondefense	474	501	501	509	519	529	539	550	562	574	587	601	2,597	5,471
Total	968	1,002	999	1,018	1,038	1,060	1,086	1,101	1,131	1,157	1,184	1,217	5,201	10,991

Continued

through 2011, the budget proposes to keep nondefense discretionary budget authority at about the amount provided so far for 2006. Under the President's proposals, that budget authority would decline from 3.3 percent of GDP this year to 2.5 percent in 2011, CBO estimates. In 2007, total nondefense discretionary budget authority

would grow by \$2.8 billion, or 0.7 percent, under the President's budget (excluding supplemental appropriations as well as funding for research and preparedness related to avian flu). Within that total, budget authority would rise for some activities and fall for others (see Table 1-7).

Table 1-6.**Continued**

(Billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007- 2011	Total, 2007- 2016
Difference (President's budget minus baseline)														
Budget Authority														
Defense	0	70	10	-30	-22	-25	-27	-27	-28	-28	-29	-29	-95	-236
Nondefense														
Homeland security ^b	0	*	1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	0	22	-35	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	0	22	-34	-46	-56	-65	-75	-77	-79	-81	-83	-86	-275	-681
Total	0	92	-25	-76	-78	-90	-101	-104	-107	-109	-112	-115	-370	-916
Outlays														
Defense	0	22	35	-6	-16	-21	-25	-26	-27	-28	-28	-29	-33	-171
Nondefense														
Homeland security ^b	0	*	*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	0	1	*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Subtotal, nondefense	0	1	*	-17	-35	-50	-68	-74	-77	-80	-82	-84	-170	-567
Total	0	23	35	-23	-52	-71	-93	-100	-104	-107	-110	-113	-203	-738

Source: Congressional Budget Office.

Notes: n.a. = not applicable (no details have been provided for discretionary spending after 2007); * = between -\$500 million and \$500 million.

Discretionary outlays derive from both budget authority and obligation limitations. Spending from the Highway Trust Fund and the Airport and Airway Trust Fund is subject to such limitations. Budget authority for those programs is provided in authorizing legislation and is not considered discretionary.

- The President's budget specifies total discretionary spending only through 2011. CBO projected discretionary spending after 2011 under the President's budget using its baseline rates of inflation.
- The amounts shown here reflect net spending for homeland security activities (\$3 billion to \$4 billion in spending per year is offset by fees and other receipts). CBO's classification of homeland security funding is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some of the department's activities (such as disaster relief) are not included in the Administration's definition of homeland security, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within that definition. About 60 percent of all spending considered to be for homeland security is for activities outside the Department of Homeland Security.

The largest funding increase in dollar terms would be for international affairs programs. That category of spending would receive an additional \$3.7 billion, or 11.9 percent, in 2007, mainly for the Millennium Challenge Corporation, the global HIV/AIDS Initiative, and economic support for other countries. Funding for veterans' benefits and services would increase by \$2.9 billion, or 8.7 percent, primarily to provide medical care to veterans and other beneficiaries.

In addition, budget authority for activities designated as relating to homeland security would rise by about \$2 billion, or 6.6 percent, in 2007 under the President's budget. About half of that increase would go to the Coast Guard, whose funding would grow from \$1.5 billion to \$2.5 billion. Other agencies that would receive additional funding in 2007 include the Centers for Disease Control and Prevention, the National Institutes of Health, and the Federal Bureau of Investigation. Obligation limita-

Table 1-7.

Comparison of Discretionary Budget Authority Enacted or Requested for 2006 and Requested by the President for 2007, by Budget Function

(Billions of dollars)

	2006			
	Regular Funding Enacted	Supplemental Funding Already Enacted ^a	Supplemental Funding Requested ^a	Total Funding
Defense Discretionary	432.4	55.9	69.9	558.2
Nondefense Discretionary				
International affairs	31.4	0.2	4.2	35.8
General science, space, and technology	24.5	0.4	0	24.8
Energy	3.8	*	0	3.8
Natural resources and environment	30.2	3.4	1.7	35.3
Agriculture	5.9	0.1	*	6.1
Commerce and housing credit	1.9	0.1	0	2.0
Transportation	24.7	3.0	0.1	27.8
Community and regional development	13.2	-11.2	15.2	17.2
Education, training, employment, and social services	78.2	1.8	0	80.0
Health	50.8	3.4	0	54.2
Medicare (Administrative costs)	4.9	0	0	4.9
Income security	47.1	0.5	0	47.6
Social Security (Administrative costs)	4.4	0	0.2	4.6
Veterans' benefits and services	33.2	0.6	0.6	34.4
Administration of justice	39.5	0.3	0.2	39.9
General government	16.4	0.1	0.1	16.5
Allowances for emergencies and other needs	0	0	0	0
Subtotal, nondefense discretionary	410.0	2.6	22.3	435.0
Total Discretionary	842.4	58.5	92.2	993.1
Memorandum:				
Transportation Obligation Limitations ^b	47.3	0	0	47.3

Source: Congressional Budget Office.

Note: n.a. = not applicable; * = between -\$50 million and \$50 million.

a. Mostly for military operations in Iraq and Afghanistan and for hurricane relief.

b. Spending from the Highway Trust Fund and the Airport and Airway Trust Fund is provided through obligation limitations. Budget authority for those programs is provided in authorizing legislation and is not considered discretionary.

2007			Change in Regular Funding, 2006-2007	
Regular Funding Requested	Supplemental Funding Requested	Total Funding	Billions of Dollars	Percent
460.1	50.1	510.2	27.6	6.4
35.2	0	35.2	3.7	11.9
26.1	0	26.1	1.7	6.8
3.8	0	3.8	*	-0.2
28.2	0	28.2	-2.0	-6.7
5.7	0	5.7	-0.2	-3.0
3.1	0	3.1	1.2	61.2
22.9	0	22.9	-1.8	-7.2
11.7	0	11.7	-1.5	-11.0
74.7	0	74.7	-3.5	-4.4
50.7	2.3	53.0	-0.1	-0.1
5.0	0	5.0	0.1	1.1
47.8	0	47.8	0.7	1.4
4.8	0	4.8	0.4	9.9
36.1	0.1	36.2	2.9	8.7
39.8	0	39.8	0.3	0.8
17.2	0	17.2	0.8	5.0
*	0	*	*	n.a.
412.7	2.4	415.1	2.8	0.7
872.8	52.6	925.3	30.4	3.6
50.4	0	50.4	3.2	6.7

tions that govern spending from the Highway and Airport and Airways Trust Funds would rise by \$3.2 billion, or 6.7 percent.

Other areas of the budget would see their funding decline in 2007 under the President's proposals. The category of education, training, employment, and social services would face the largest cut: \$3.5 billion, or 4.4 percent. The biggest reductions in that category would apply to grants for social services, vocational education, higher education, and employment and training programs. Reductions in funding for natural resources and the environment would total \$2.0 billion, or 6.7 percent, mainly relating to activities of the Army Corps of Engineers and the Natural Resources Conservation Service.

Grants to state and local governments (other than for disaster relief programs) make up about one-third of the nondefense discretionary funding for 2007 in the President's budget—a total of \$165 billion.¹⁵ That amount is about \$3 billion, or 2 percent, less than the corresponding figure for 2006. The budget proposes to reduce grant funding for criminal justice programs by 56 percent, for economic development by 30 percent, for homeland security by 10 percent, and for social services programs by 7 percent. At the same time, grants for transportation programs (including obligation ceilings for highway and transit trust fund programs) would increase by 6 percent.

Differences Between CBO's and the Administration's Budget Estimates

As noted above, CBO's estimate of the deficit in 2006 under the President's budget (\$371 billion) is \$52 billion less than the Administration's estimate (\$423 billion). That difference narrows over the 2007-2011 period (see Table 1-4 on page 7). The cumulative five-year deficits projected by CBO and the Administration differ by only \$40 billion—equivalent to less than 0.3 percent of projected outlays during that period. CBO's estimate of outlays over those five years is \$130 billion lower than the Administration's, and its estimate of revenues is \$90 billion lower.

15. That amount includes obligation ceilings for highway and transit trust fund programs.

Baseline Differences

In conjunction with the President's budget request, the Administration published a current-services baseline extending through 2011. In that baseline, as in CBO's, the deficit declines each year through 2011. But the Administration's baseline shows a cumulative shortfall of \$948 billion over the 2007-2011 period, whereas CBO projects a \$1.1 trillion deficit for those five years (see Table 1-8 on page 24).

Conceptual differences account for most of the gap between the two baselines. CBO constructs its baseline as specified in the Balanced Budget and Emergency Deficit Control Act of 1985. The Administration, however, has deviated from prior practices in three ways. First, its current-services baseline assumes that the major tax-law changes enacted in EGTRRA and JGTRRA will be extended rather than expire as scheduled. That conceptual difference primarily affects revenues. Second, the Administration has not extrapolated into future years the \$33 billion in supplemental appropriations (mostly for hurricane relief) or the \$50 billion in funding for operations in Iraq and Afghanistan provided so far this year.¹⁶ Third, the Administration has adjusted the way it accounts for increases in pay when projecting discretionary spending.

With such conceptual differences excluded, the cumulative baseline deficits that CBO and the Administration project for the 2007-2011 period would differ by roughly \$80 billion (or 0.5 percent of projected outlays) rather than by \$124 billion.

Differences in Economic Assumptions

CBO and the Administration are forecasting generally similar values for the economic variables used to estimate revenues and outlays (see Table 1-9 on page 26). On the whole, however, the Administration's economic forecast implies higher revenues, slightly higher outlays, and a moderately more favorable outcome for the budget. The Administration's economic outlook decreases the cumula-

16. The supplemental appropriation act for hurricane relief also rescinded \$23 billion in funds previously provided to the Federal Emergency Management Agency (FEMA), but those rescissions are not extended into the future in CBO's baseline. Similarly, the transfer of nearly \$1 billion from FEMA's disaster relief account to the Small Business Administration (SBA) is not extended into the future (although SBA's disaster loan payments are assumed to continue).

tive deficit for the 2007-2011 period by about \$166 billion compared with CBO's economic outlook.

Most of that difference appears in revenue estimates. The Administration's forecast leads to higher revenue projections for two main reasons. First, its forecast for the growth of nominal GDP is higher than CBO's over the 2008-2011 period, which tends to raise its projections of all types of income. Second, it estimates that wages and salaries—a category of income that is extremely important for projecting revenues—will constitute a larger share of GDP than CBO projects. Both of those differences occur primarily because the Administration anticipates higher inflation from 2007 through 2011 than CBO does, which more than offsets CBO's higher projection for the growth of real (inflation-adjusted) GDP in 2006 and 2007.

In terms of outlays, the Administration's economic outlook leads to slightly higher estimates mainly because it forecasts greater growth in the consumer price index for wage earners and clerical workers—the measure of inflation used for cost-of-living adjustments in Social Security and other programs. The fact that the Administration projects higher long-term interest rates over the 2007-2011 period than CBO does also tends to raise its outlay projections by increasing debt-service costs. However, that effect is partially offset because the Administration's forecast of short-term interest rates is lower than CBO's.

Total Outlay Differences

For 2006, CBO's estimate of outlays under the President's budget is \$34 billion below the Administration's (see Table 1-4 on page 7). CBO anticipates \$25 billion less in outlays for mandatory programs than the Administration projects, largely because of baseline differences. Medicare accounts for about \$11 billion of that gap. Contributing to the gap is CBO's lower projection of spending for the Part D prescription drug program in 2006, which incorporates data made available in mid-February that show lower enrollment than expected. CBO's projections of 2006 outlays are also \$4 billion less than the Administration's for unemployment compensation, \$3 billion less for Medicaid, and \$2 billion less for student loans.

CBO also expects lower discretionary outlays this year under the President's budget than the Administration

does. That difference, \$7 billion, largely results from different expectations about how quickly funds requested for operations in Iraq and Afghanistan would be spent.

For the 2007-2011 period, CBO's and the Administration's projections of total outlays under the President's budget differ by \$130 billion (or 0.9 percent of total outlays). CBO estimates that mandatory outlays will be \$98 billion lower than the Administration does. Much of that gap—\$63 billion—stems from differing estimates of spending for the President's plan to allow workers to establish individual investment accounts under Social Security (see Box 1-1 on page 12).

Another \$31 billion of the difference in projected mandatory outlays over five years results from differing economic assumptions (and their impact on the baseline). In particular, CBO's estimate of Social Security outlays between 2007 and 2011 is \$30 billion less than the Administration's because it assumes lower cost-of-living adjustments and lower wages than the Administration does. (In all, CBO's projection of Social Security spending—other than for individual accounts—is 1.1 percent lower than the Administration's over the 2007-2011 period.)

Other differences in projections of mandatory outlays are relatively small and largely offset each other. CBO anticipates higher spending than the Administration does for Medicare and Medicaid after 2007 but lower spending for veterans' programs and unemployment benefits.

Estimates of discretionary spending under the President's budget partially offset those differences, with CBO's projection for the 2007-2011 period exceeding the Administration's by \$37 billion. Part of that difference reflects estimates of outlays from proposed supplemental appropriations for 2006. CBO estimates that less will be spent this year and more in 2007 than the Administration does. Most of the remaining difference stems from projections of the rate at which the budget authority requested for 2008 to 2011 will be spent.

Finally, CBO's projection of net interest outlays over the 2007-2011 period is \$69 billion below the Administration's estimate. That difference occurs mainly because CBO projects lower deficits under the President's budget as well as lower long-term interest rates than the Administration does.

Table 1-8.**Comparison of CBO's March Baseline and the Administration's February Current-Services Baseline**

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	Total, 2007- 2011
CBO's March 2006 Baseline							
Revenues	2,313	2,461	2,598	2,743	2,883	3,139	13,825
On-budget	1,704	1,820	1,922	2,032	2,136	2,357	10,266
Off-budget	608	642	676	712	747	782	3,559
Outlays							
Mandatory	1,429	1,484	1,569	1,655	1,753	1,875	8,336
Discretionary	1,002	999	1,018	1,038	1,060	1,086	5,201
Net interest	218	243	262	274	286	295	1,361
Total	2,648	2,726	2,849	2,968	3,099	3,256	14,898
On-budget	2,220	2,280	2,388	2,488	2,601	2,739	12,494
Off-budget	428	447	461	480	498	517	2,403
Deficit (-) or Surplus	-336	-265	-250	-224	-216	-117	-1,072
On-budget	-516	-460	-466	-456	-465	-382	-2,228
Off-budget	180	195	215	232	249	265	1,156
Administration's February 2006 Current-Services Baseline							
Revenues	2,301	2,444	2,597	2,729	2,901	3,064	13,735
On-budget	1,691	1,802	1,918	2,013	2,142	2,262	10,137
Off-budget	610	642	679	716	758	802	3,598
Outlays							
Mandatory	1,451	1,495	1,575	1,668	1,762	1,883	8,382
Discretionary	998	962	957	973	990	1,017	4,900
Net interest	219	244	266	284	298	310	1,402
Total	2,669	2,701	2,798	2,925	3,050	3,210	14,683
On-budget	2,240	2,251	2,335	2,441	2,544	2,682	12,252
Off-budget	428	450	463	484	506	528	2,431
Deficit (-) or Surplus	-367	-257	-201	-196	-149	-146	-948
On-budget	-549	-449	-416	-428	-402	-420	-2,115
Off-budget	182	192	216	233	252	274	1,167

Continued**Total Revenue Differences**

If the President's proposals were enacted, revenues would total \$2.3 trillion this year, CBO estimates—\$19 billion more than the Administration projects. For the 2007-2011 period, however, CBO's projection of \$13.5 trillion in total revenues is lower than the Administration's by \$90 billion, or 0.7 percent.¹⁷

As discussed above, differences in economic assumptions cause CBO's estimates of revenues under the President's

17. Revenue projections in CBO's baseline exceed those in the Administration's current-services baseline by \$11 billion in 2006 and \$91 billion over the 2007-2011 period (see Table 1-8). Conceptual differences between the two baselines explain why CBO projects higher baseline revenues, but lower revenues under the President's budget, than the Administration does.

Table 1-8.**Continued**

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	Total, 2007- 2011
Difference (CBO minus Administration)							
Revenues	11	17	1	14	-17	75	91
On-budget	13	18	3	19	-6	95	129
Off-budget	-2	-1	-3	-4	-11	-20	-38
Outlays							
Mandatory	-23	-11	-6	-12	-9	-8	-46
Discretionary	4	37	61	65	70	69	301
Net interest	-1	*	-4	-10	-12	-15	-41
Total	-20	26	51	43	49	46	214
On-budget	-20	29	53	47	57	57	242
Off-budget	*	-3	-2	-4	-8	-10	-28
Deficit or Surplus ^a	31	-8	-50	-29	-66	29	-124
On-budget	33	-11	-49	-28	-63	38	-113
Off-budget	-2	3	*	-1	-3	-9	-11

Sources: Congressional Budget Office; Office of Management and Budget.

Notes: * = between -\$500 million and \$500 million.

The Administration's baseline deviates from the concepts delineated in the Balanced Budget and Emergency Deficit Control Act of 1985 in two significant ways: it assumes that most tax provisions enacted in 2001 and 2003 will be extended rather than expire as scheduled, and it does not extrapolate supplemental appropriations provided for 2006 into future years.

- a. Positive numbers denote that the Administration's deficit estimate is higher than CBO's, and negative numbers denote that the Administration's deficit estimate is lower than CBO's.

budget to be smaller than the Administration's. CBO's projections for wages and salaries, the most highly taxed category of income, are below the Administration's for all years of the 2007-2011 period, and CBO's projections for corporate profits are lower than the Administration's for each year through 2009. For those and other economic reasons, CBO projects \$15 billion less in receipts than the Administration does for 2006 and \$213 billion less for the 2007-2011 period.

Some of the difference related to economic projections is offset by other factors (classified as technical differences). In particular, CBO estimates a higher revenue yield from any given economic projection because it estimates a higher average tax rate on corporate profits as measured in the national income and product accounts. Such technical differences cause CBO's revenue projections to

exceed the Administration's by \$34 billion for 2006 and \$123 billion for the 2007-2011 period.

Little of that overall technical difference reflects discrepancies between CBO's and the Administration's estimates of the effects of the President's revenue proposals. CBO and JCT estimate that the President's proposals would reduce revenues by a total of about \$282 billion between 2007 and 2011—just \$2 billion more than the Administration estimates. Differences do exist, however, in estimates of specific proposals.

In a number of cases, CBO's and JCT's estimates of revenue proposals point to larger deficits under the President's budget than the Administration's estimates do. For example, extending the EGTRRA and JGTRRA provisions that affect tax rates, the child tax credit, and income

Table 1-9.**Comparison of CBO's, the Administration's, and Private-Sector Economic Projections for Calendar Years 2006 to 2011**

	Estimated 2005	Forecast		Projected Annual Average, 2008-2011
		2006	2007	
Nominal GDP (Billions of dollars)				
CBO	12,494	13,262	13,959	16,954 ^a
Administration	12,482	13,210	13,949	17,177 ^a
March <i>Blue Chip</i>	12,486	13,253	13,954	17,107 ^b
Nominal GDP (Percentage change)				
CBO	6.5	6.1	5.3	5.0
Administration	6.4	5.8	5.6	5.3
March <i>Blue Chip</i>	6.4	6.0	5.3	5.2
Real GDP (Percentage change)				
CBO	3.6	3.6	3.4	3.1
Administration	3.6	3.4	3.3	3.2
March <i>Blue Chip</i>	3.5	3.4	3.0	3.1
GDP Price Index (Percentage change)				
CBO	2.7	2.4	1.8	1.8
Administration	2.7	2.4	2.2	2.1
March <i>Blue Chip</i>	2.8	2.6	2.2	2.1
Consumer Price Index ^c (Percentage change)				
CBO	3.4	2.8	2.2	2.2
Administration	3.4	3.0	2.4	2.4
March <i>Blue Chip</i>	3.4	2.9	2.4	2.3
Unemployment Rate (Percent)				
CBO	5.1	5.0	5.0	5.2
Administration	5.1	5.0	5.0	5.0
March <i>Blue Chip</i>	5.1	4.8	4.9	4.9

Continued

tax brackets would reduce revenues by more than \$94 billion in 2011, according to CBO's and JCT's calculations. That figure is almost \$17 billion more than the Administration's estimate. Likewise, CBO's and JCT's estimate of the cost in 2007 of continuing expired AMT provisions through this year (\$26 billion) is \$6 billion more than the Administration's estimate. (CBO's and JCT's projection for 2006, however, is \$7 billion less than the Administration's.) In addition, CBO and JCT estimate that expanding tax-free savings accounts would boost revenues by about \$15 billion through 2011, which is \$12 billion less than the Administration's estimate. (Their projection that the proposal would reduce revenues by \$0.3 billion over the full 2007-2016 period is very close to the Administration's estimate, however.)

Differences in estimates for those revenue proposals are largely offset by several cases in which CBO and JCT project smaller revenue reductions than the Administration does. For instance, CBO and JCT estimate that the proposal to expand HSAs would lower revenues by about \$5 billion over the 2007-2011 period, whereas the Administration estimates a \$29 billion decrease. Similarly, CBO and JCT estimate smaller revenue reductions from extending and expanding expensing for small businesses (a difference of \$8 billion for those two proposals) and from allowing a tax deduction for the cost of high-deductible health insurance (a difference of \$6 billion).

Table 1-9.**Continued**

	Estimated 2005	Forecast		Projected Annual Average, 2008-2011
		2006	2007	
Three-Month Treasury Bill Rate (Percent)				
CBO	3.2	4.5	4.5	4.4
Administration	3.2	4.2	4.2	4.3
March <i>Blue Chip</i>	3.2	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)				
CBO	4.3	5.1	5.2	5.2
Administration	4.3	5.0	5.4	5.6
March <i>Blue Chip</i>	4.3	4.8	5.0	5.5
Tax Bases ^d (Billions of dollars)				
Corporate book profits				
CBO	1,434	1,451	1,438	1,555
Administration	1,425	1,505	1,497	1,500
Wages and salaries				
CBO	5,723	6,050	6,383	7,785
Administration	5,745	6,095	6,459	8,028
Tax Bases ^d (Percentage of GDP)				
Corporate book profits				
CBO	11.5	10.9	10.3	9.4
Administration	11.4	11.4	10.7	9.5
Wages and salaries				
CBO	45.8	45.6	45.7	45.9
Administration	46.0	46.1	46.3	46.6

Sources: Congressional Budget Office; Office of Management and Budget; Aspen Publishers, Inc., *Blue Chip Economic Indicators* (March 10, 2006); Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

Notes: GDP = gross domestic product.

Percentage changes are year over year.

- a. Level in 2011.
- b. Estimated by CBO.
- c. The consumer price index for all urban consumers.
- d. The *Blue Chip* survey does not include projections of tax bases.

The Economy Under the President's Budget and Under CBO's Baseline Policy Assumptions

In addition to providing estimates of the cost of the President's budgetary proposals (see Chapter 1), the Congressional Budget Office analyzed how those policies—in comparison with the policies incorporated in its baseline—would affect the economy. CBO concluded that under the tax and spending policies in the President's budget, economic output during the first five years of the current baseline projection period—2007 to 2011—might be either slightly lower or slightly higher, on average, than it would be under the policies in the baseline. Under most sets of assumptions, output over the second five years—2012 to 2016—would be higher under the President's policies, according to CBO's estimates. The proposals' effects tend to be more positive in the second period primarily because that span includes a greater number of years in which the largest reductions in marginal tax rates on labor would be effective (those stemming from proposals to extend certain tax cuts set to expire after 2010) and a greater number of years in which proposed government spending for goods and services would fall well below the levels in CBO's baseline. However, CBO's analysis suggests that the proposals' overall impact on output is likely to be modest, affecting its average over the full 10-year projection period (2007 to 2016) by 0.4 percent or less, depending on the assumptions used.

The limited extent of the proposed policies' effects on output stems in part from the small magnitude—relative to the overall economy—of the proposals' budgetary impact. For example, in CBO's estimation, revenues from 2007 to 2011 under the President's proposals (excluding economic effects) would be lower by 0.4 percent of cumulative gross domestic product than they would be under the policies reflected in CBO's baseline. Spending, including interest on government debt, would be lower by 0.3 percent of cumulative GDP. Moreover, various pro-

posals in the budget have offsetting effects: some tend to imply greater output, and some tend to imply less.

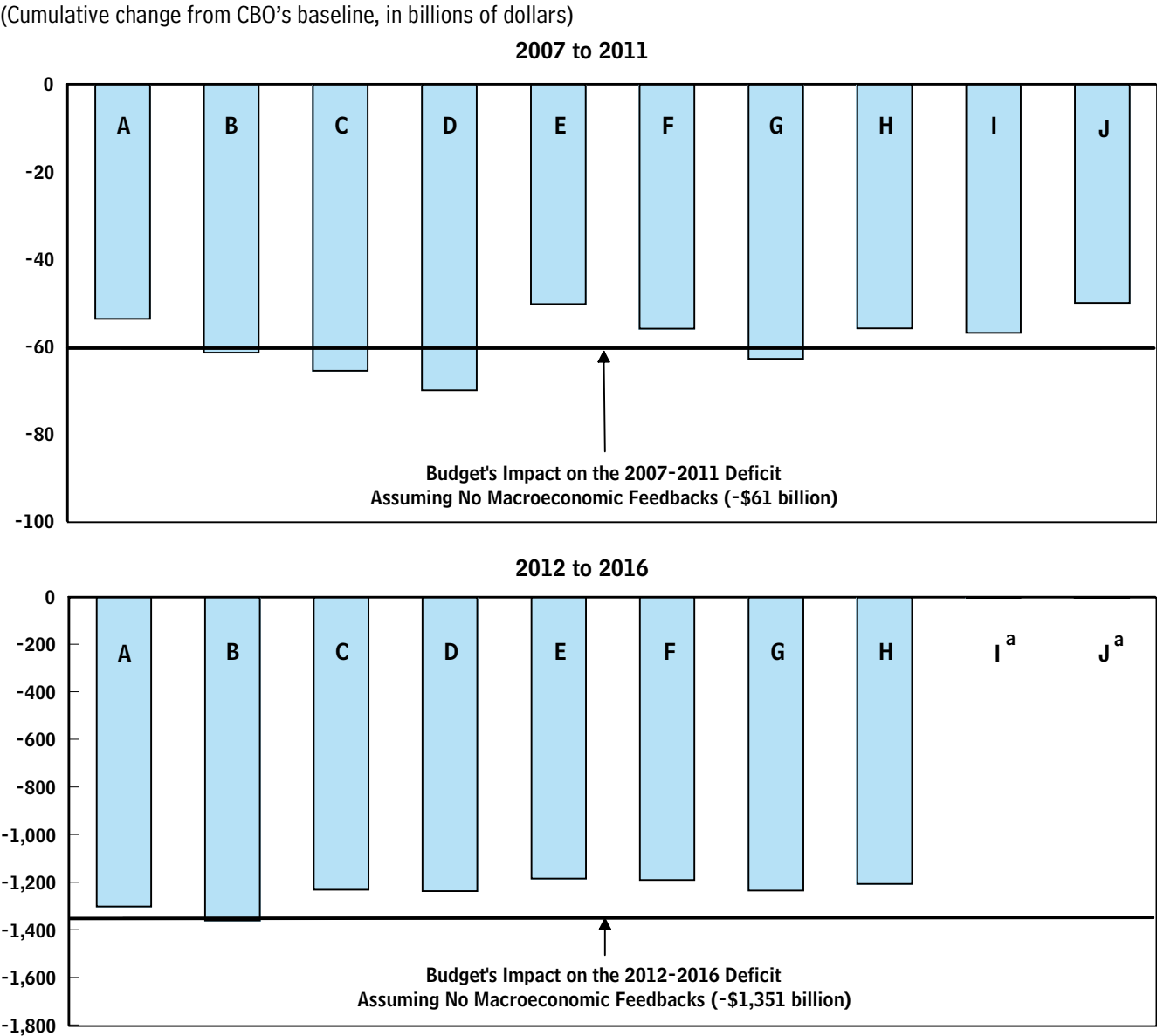
The macroeconomic effects of the proposals could in turn alter their budgetary cost. CBO estimates that under its baseline economic assumptions, the President's budgetary proposals will increase the cumulative deficit for the five years from 2007 to 2011—relative to the deficit under the baseline's policy assumptions—by \$61 billion (0.1 percent of cumulative GDP). If the budgetary effects of the supply-side economic changes resulting from those proposals were included in the estimate, the increase in the cumulative deficit would range from \$50 billion to \$70 billion (see Figure 2-1 and Table 2-1).

For the years 2012 to 2016, the President's proposals, as assessed using the baseline's economic assumptions, would increase the cumulative deficit by \$1,351 billion (1.4 percent of cumulative GDP). If the budgetary effects of the economic changes resulting from the proposals were also considered, the projected increase in the cumulative deficit over that period would range from as much as \$1,357 billion (1.4 percent of cumulative GDP) to as little as \$1,181 billion (1.2 percent of cumulative GDP), with most estimates lower than the baseline projection of \$1,351 billion.

How Fiscal Policy Affects the Economy

Budgetary policies may affect the economy in a variety of ways. Changes in the tax rates that people face on their income may affect incentives to work and save; government spending for goods and services may reduce the resources available for investment; and spending and tax policies may influence the overall level of demand in the economy. Those factors and other possible economic influences may be broadly divided into long-run effects, which apply largely to the supply side of the economy,

Figure 2-1.
CBO's Estimates, Using Various Models, of How the President's Budget Would Affect the Deficit After Accounting for Economic Effects



Source: Congressional Budget Office.

Notes: The estimates in the panels above reflect the supply-side effects of the President's proposals on the economy but exclude demand-side economic impacts, as explained in the text. A negative change indicates an increase in the cumulative deficit relative to CBO's baseline.

CBO's analysis used the following models (which are described in the text): (A) "textbook" high model, (B) "textbook" low model, (C) closed-economy life-cycle model with lower government spending after 2016, (D) closed-economy life-cycle model with higher taxes after 2016, (E) open-economy life-cycle model with lower government spending after 2016, (F) open-economy life-cycle model with higher taxes after 2016, (G) infinite-horizon model with lower government consumption after 2016, (H) infinite-horizon model with higher taxes after 2016, (I) Macroeconomic Advisers' model, and (J) Global Insight's model.

a. Because this model is designed primarily to capture business-cycle developments, which are hard to predict beyond a few years, CBO did not compute an estimate for the 2012-2016 period.

Table 2-1.

CBO's Estimates of How the President's Budget Would Affect the Deficit After Accounting for Economic Effects

(Cumulative change from CBO's baseline, in billions of dollars)

	2007 to 2011	2012 to 2016
Growth Models		
<i>Without Forward-Looking Behavior</i>		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	-54	-1,298
Low (Hours worked respond weakly to tax-rate changes)	-61	-1,357
<i>With Forward-Looking Behavior</i>		
Closed-Economy Life-Cycle Model		
Lower government spending after 2016	-65	-1,227
Higher taxes after 2016	-70	-1,234
Open-Economy Life-Cycle Model		
Lower government spending after 2016	-50	-1,181
Higher taxes after 2016	-56	-1,187
Infinite-Horizon Model		
Lower government spending after 2016	-63	-1,231
Higher taxes after 2016	-56	-1,203
Macroeconometric Models		
<i>Supply-Side Contribution</i>		
Macroeconomic Advisers' Model	-57	n.a.
Global Insight's Model	-50	n.a.
<i>Supply-Side and Demand-Side Contributions</i>		
Macroeconomic Advisers' Model	-59	n.a.
Global Insight's Model	-88	n.a.
Memorandum:		
CBO's Estimate of the Budgetary Effects of the President's Proposals Under Baseline Economic Assumptions	-61	-1,351

Source: Congressional Budget Office.

Notes: A negative number indicates an increase in the cumulative deficit relative to CBO's baseline.

The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: in the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2016. CBO chose two alternatives—cutting government purchases of goods and services and transfer payments or raising marginal tax rates.

n.a. = not applicable.

and short-run effects, which largely affect the demand side.

The economy's underlying potential to produce goods and services depends on the size and quality of both the labor force and the stock of productive capital (such as factories and information systems) as well as on the level of technological know-how. Analysts refer to long-term changes in those three determinants of potential output as supply-side changes because they alter the quantity of goods and services that the economy is capable of supplying on a sustainable basis. Such supply-side changes have a lasting effect on the economy.

In the short run, however, economic output may deviate from its potential level, as the total demand for goods and services moves above and below that level, causing employment to rise and fall and the stock of capital to be used more or less intensively. Those movements are referred to as demand-side, or cyclical, variations.¹ Unlike movements on the supply side of the economy, cyclical changes are temporary: built-in corrective forces usually tend to move the economy back toward the sustainable potential level determined by the supply side.

Both supply-side and demand-side economic developments depend on the choices that millions of individuals make about what and how much to buy, how much to save and what assets to hold, and where and how much to work. Such developments also depend on the choices that firms make about how much to invest, how many workers to hire, and how many goods or services to produce. The government plays a crucial role in establishing the legal and institutional framework within which the economy operates as well as an overall level of government spending and taxation. Within that general structure, however, modest changes in government spending and taxation policies influence economic performance only to a limited degree.

Supply-Side Effects

The supply-side effects of the President's taxation and spending proposals might include influences on the quantity and quality of labor, the size and composition of the capital stock, and technological progress. Changes in any or all of those factors can alter potential output.

1. Supply-side factors such as energy prices may also trigger cyclical movements in the economy.

The Quantity and Quality of Labor. Potential output is strongly influenced by the overall quantity and quality of labor in the economy. Put simply, a long-term increase in the overall number of hours worked raises the economy's potential to generate output. Moreover, increases in workers' educational attainment, level of training, and experience or degree of effort on the job raise the quality of each hour worked, which will also increase potential output. Some analysts argue that certain policies in the President's budget—for example, making current tax rates permanent—will ultimately affect the quality of labor. However, the channels through which budgetary policies influence that supply-side variable and the pace at which such effects occur are not well understood. For that reason, CBO's analysis concentrated on the hours of labor supplied, which the President's proposals would affect in two main ways.

First, several provisions, such as the extension of the child tax credit, would increase people's after-tax income but would not significantly change the marginal tax rates on income resulting from labor. (In general, the marginal rate is the rate on the next dollar of income.) A rise in after-tax income without a change in marginal rates tends to reduce the number of hours that people want to work because they can maintain the same standard of living with less work.

Second, some of the President's proposed policies, such as the extension of the marginal tax rates enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, would increase both after-tax compensation for each additional hour of work and overall after-tax income. Evaluating how that kind of change would affect the number of hours people work is complicated by the fact that the policy would have opposing effects: people would earn more for each extra hour they worked, which would tend to encourage them to supply more labor, but they could also work fewer hours and earn the same after-tax income, which would tend to discourage work. Studies generally have found that, on balance, reductions in marginal tax rates such as those the President has proposed will increase the hours of labor that workers supply, primarily because those reduced tax rates will draw secondary earners (for example, the spouse of a household's primary breadwinner) into the labor force.

To summarize as a single number the changes proposed by the President in the schedule of marginal tax rates, CBO estimated the impact those changes would have on

Table 2-2.**CBO's Estimates of Effective Federal Marginal Tax Rates on Labor Income**

(Percent)

Calendar Year	Tax Rate Under Current Law	Tax Rate Under the President's Budget	Difference	
			Percentage Points	Percent
2006	27.6	27.1	-0.5	-1.9
2007	27.8	27.8	0	0
2008	28.1	28.1	0	0
2009	28.4	28.4	0	0
2010	28.6	28.6	0	0
2011	30.4	28.9	-1.5	-4.9
2012	30.5	29.1	-1.4	-4.7
2013	30.7	29.3	-1.3	-4.4
2014	30.8	29.6	-1.2	-3.9
2015	31.0	29.8	-1.2	-3.9
2016	31.2	30.0	-1.1	-3.6

Source: Congressional Budget Office.

Note: The effective federal marginal tax rate on income from labor is the share of the last dollar of such income that is taken by taxes—specifically, federal individual income and payroll taxes.

the effective marginal tax rate on labor income—the rate at which the average additional dollar of a worker's compensation for labor is taxed (see Table 2-2). Under the President's policies, that rate would fall—relative to CBO's baseline—by about 2 percent in 2006, largely as a result of the proposal to extend for one year an increase in the exemptions allowed under the alternative minimum tax. However, the rates would be little changed over the 2007-2010 period; instead, the biggest rate changes would occur for the years 2011 to 2016—because the President proposes to make permanent various reductions in taxes that are scheduled to expire after 2010. For the 2011-2016 period, the average effective marginal tax rate on labor income would be between 3 percent and 5 percent lower under the President's proposals than under the current-law policies incorporated in CBO's baseline.

The President's proposals might also influence the level of the capital stock (discussed in the next section), which could change people's productivity and wages and thus affect the hours of labor they supplied. That is, if the proposals reduced investment, the stock of productive capital would be smaller and wages would be lower, which would discourage work. Conversely, increasing investment would lift wages and encourage work.

Another way in which the President's proposals might affect the hours worked in the economy would be by changing people's expectations about future government policies. Under the President's proposals, the cumulative federal budget deficit over the 10-year projection period would be larger than it would be under the policies in CBO's baseline. That higher deficit could lead people to expect that at some time after that period, fiscal policy would have to change to finance the increase in the federal government's interest payments on the money that the government had borrowed to cover the bigger deficit. Either taxes would have to be raised or spending cut.² If people expected to pay more in taxes or to receive fewer services or smaller transfer payments (such as Social Security benefits), they might try to work and save more now so they would have more resources to compensate for the increased burden in the future. In addition, if people expected to face higher tax rates on their income from labor in the future, they might try to work more before the

2. For some time, the shortfall could be made up by running larger deficits. However, the government could not follow such an approach indefinitely because interest costs would compound relative to output over time (under the assumption, which CBO's findings incorporate, that the rate of interest on government debt is higher than the rate of economic growth).

rates went up and then work less when the rates were higher.

It is difficult, however, to gauge the degree to which such foresight influences people's economic decisions. Also unclear is the time horizon that people consider in making plans and the future changes in policy that they actually expect. To illustrate the importance of those factors, CBO used various assumptions in its analysis to account for the extent of people's foresight and the expectations they might have about future policies and then assessed the differences in results.

In sum, CBO estimates, the President's budgetary proposals would probably raise the number of hours people worked in 2006 but have relatively small effects (which could be positive or negative) during the 2007-2010 period. Over the 2011-2016 period—when the reductions in marginal tax rates would be largest relative to CBO's baseline policy assumptions—the proposals would probably increase the hours of labor supplied.

The Size and Composition of the Capital Stock. The President's budgetary policies would influence the size of the capital stock primarily by affecting both public and private consumption of goods and services and therefore investment. The President's proposals would directly alter government purchases of goods and services relative to their level in CBO's baseline. For 2006 and 2007, the proposals imply that the level of such purchases will be higher than their level in the baseline—which would, in the absence of cyclical effects, tend to lessen investment in private capital by reducing the resources available for that purpose. However, from 2008 to 2016, the proposals imply that government purchases will be lower than in the baseline, which would tend to boost private investment.

The President's budgetary policies would also produce offsetting influences on private consumption of goods and services. The reductions in taxes that the budget proposes would increase after-tax income, which would tend to increase consumption, and other things being equal, a higher level of consumption might crowd out investment in capital goods. But some of the President's tax proposals—for example, extending EGTRRA's marginal income tax rates, extending the tax rates on dividends and capital gains enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003, and expanding tax-free savings accounts—could tend to reduce consumption during the

years that they were in effect. The reason is that the proposals would provide an incentive to save by lowering the effective marginal tax rates on capital income and thus increasing the after-tax rate of return on savings. (Appendix B analyzes in more detail the potential economic effects of the President's proposals for dividend and capital gains taxation, tax-free savings accounts, the estate tax, and individual accounts in Social Security.)

To summarize in one number the effects of the President's proposals on the rate of return on savings, CBO calculated the average effective marginal tax rate on capital income under the current-law policies in CBO's baseline and under the President's proposed policies (see Table 2-3). In both sets of calculations, the estimated effective tax rates were lower than they would otherwise have been because some capital income (for example, the interest that flows into tax-free savings accounts or pension funds) is not taxed. According to CBO's estimates, the effective marginal tax rate on capital income during the 2011-2016 period would average about 18 percent less under the President's proposals than under the policies in CBO's baseline. That difference is greater than the difference estimated last year for the period because for this analysis, CBO used an updated method to calculate effective tax rates that incorporates the assumption that a larger share of capital income is subject to individual income taxation.³

The reductions in taxes on capital income that the President's budget proposes would raise the rate of return on savings and affect private consumption in two opposing ways (just as lowering the marginal tax rate on labor income would have opposing effects on the supply of labor). The higher return on savings that the reductions imply would tend to increase saving and reduce current consumption. But the higher return would also increase savers' wealth by boosting their after-tax income both now and in the future—which would tend to push up their current consumption. On balance, the implications that higher returns would have for consumption might be either positive or negative. The general conclusion that researchers have drawn from empirical data is that the return on savings has a relatively small effect on how much

3. For a description of the updated method, see Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform* (October 2005), Appendix A. CBO moved to the new method because it is the approach used by most other researchers.

Table 2-3.**CBO's Estimates of Effective Federal Marginal Tax Rates on Capital Income**

(Percent)

Calendar Year	Tax Rate Under Current Law	Tax Rate Under the President's Budget	Difference	
			Percentage Points	Percent
2006 ^a	13.6	13.7	0.1	1.0
2007	13.6	13.6	0	0
2008	13.7	13.7	0	0
2009	14.4	13.3	-1.0	-7.2
2010	14.3	13.3	-1.0	-7.1
2011	16.3	13.3	-3.0	-18.4
2012	16.2	13.3	-2.9	-18.0
2013	16.2	13.3	-2.9	-17.8
2014	16.2	13.3	-2.8	-17.6
2015	16.1	13.4	-2.8	-17.2
2016	16.1	13.3	-2.8	-17.2

Source: Congressional Budget Office.

Note: The effective federal marginal tax rate on income from capital is the share of the last dollar of such income that is taken by taxes—specifically, federal individual income and corporate income taxes.

- a. The effective tax rate would increase slightly under the President's proposals in 2006 because the proposed change in the alternative minimum tax would lower the value of mortgage interest deductions in that year by more than it would lower the effective marginal tax rate on other capital income.

people spend. Nevertheless, to cover other possibilities, CBO included a range of assumptions in its analysis. For some of its estimates, CBO assumed that the rate of return on savings would have little or no effect on how much people spend; for others, CBO assumed that increasing the rate of return on savings would reduce consumption—and increase saving—significantly.

Finally, as described earlier, the larger (relative to CBO's baseline estimate) cumulative 10-year deficit under the President's budgetary proposals might lead some people to anticipate changes in policy in the future. If people expected higher taxes, smaller transfer payments, or fewer government services in the years to come, they might reduce their spending and build up their savings to compensate for those anticipated policies. CBO used a range of assumptions about those expectations—and about other factors—in its analysis, and the estimated effects varied depending on the assumptions used: under some assumptions, the domestically owned capital stock was projected to be smaller when the policies in the President's budget were in place than when those in CBO's baseline were in effect; under other assumptions, the capital stock was projected to be larger. In general, however, the differences were modest.

In addition to changes in the level of the capital stock, changes in the mix of different types of capital within that stock may affect potential output. Among the policies in the President's budget, the proposal to extend the lower tax rates on corporate dividends and capital gains would probably have the biggest effect on the composition of the capital stock because the proposal would lessen taxes on personal income received from the corporate sector and thus encourage some investors to shift capital from the noncorporate to the corporate sector. Currently, some corporate income is taxed once at the level of the firm, through the corporate income tax, and again at the personal level, through the individual income tax on dividends and capital gains. That tax treatment distorts the way that capital is allocated in the economy because it discourages investment in the corporate sector relative to investment in the housing and noncorporate business sectors. As a result, less capital is held in the corporate sector than is optimal for the economy's efficient operation. Extending lower tax rates on dividends and capital gains would reduce that distortion, which could increase economic output.

The taxation of dividends and capital gains also encourages firms to finance investment by borrowing rather

than by issuing stock. Because firms may deduct their interest payments on debt (for example, bonds they have issued) from their taxable income, they can lessen the tax they pay. (The interest payments will then be taxed only once, at the individual level.) The tax treatment of interest payments on debt may influence firms' decisions about financing and lead to inefficient allocation of the economy's resources. Extending the current tax rates on dividends and capital gains would lessen such inefficiency relative to that under the baseline's assumption that the tax rates on those categories of income will rise after 2008.

Technological Progress. New and improved technical processes and products are the source of most long-term growth in productivity, and the President's budgetary proposals could affect the economy by influencing the rate of such progress. Researchers, however, lack a basis for estimating how taxation and spending policies affect technological innovation. Because so little is understood about the genesis of such innovation, CBO for the most part has not incorporated in its analysis effects on technological progress arising from the President's proposals.⁴

Demand-Side (Cyclical) Effects

The federal government's policies for taxation and spending also affect the economy by adding to or subtracting from the total demand for goods and services. Increases in demand may cause firms to temporarily gear up production and hire more workers; decreases in demand may have the opposite effects. From a demand-side perspective, budgetary policies that reduce private and public consumption might slow the pace of the economy's current cyclical expansion.

Demand-side effects, however, are relatively fleeting: they can only temporarily raise or lower output beyond what it would otherwise have been because built-in economic forces tend to move output toward its sustainable potential level. Moreover, policies that increase demand by raising government purchases or private consumption are likely to lower output in the long run because such poli-

cies tend eventually to decrease investment and the size of the capital stock.

A Description of the Models Used by CBO and Their Results

In estimating the economic effects of the President's budgetary proposals relative to those arising from the policy assumptions in the baseline, CBO used several different economic models that in some respects are similar but that capture different features of the economy and reflect different ways of thinking about it. The models fall into two broad categories. Three estimate only supply-side effects. The other two are commercial macroeconomic models that emphasize the business-cycle aspects of the economy and are designed primarily to analyze demand-side effects—although they incorporate some supply-side influences as well. (Figure 2-2 presents, year by year, the impact of the President's proposals on some of the key inputs for CBO's various models—effective tax rates on labor and capital and the size of the deficit. Table 2-4 presents details of CBO's baseline projections of GDP and other economic variables.)

Ten-Year Analysis of Supply-Side Effects

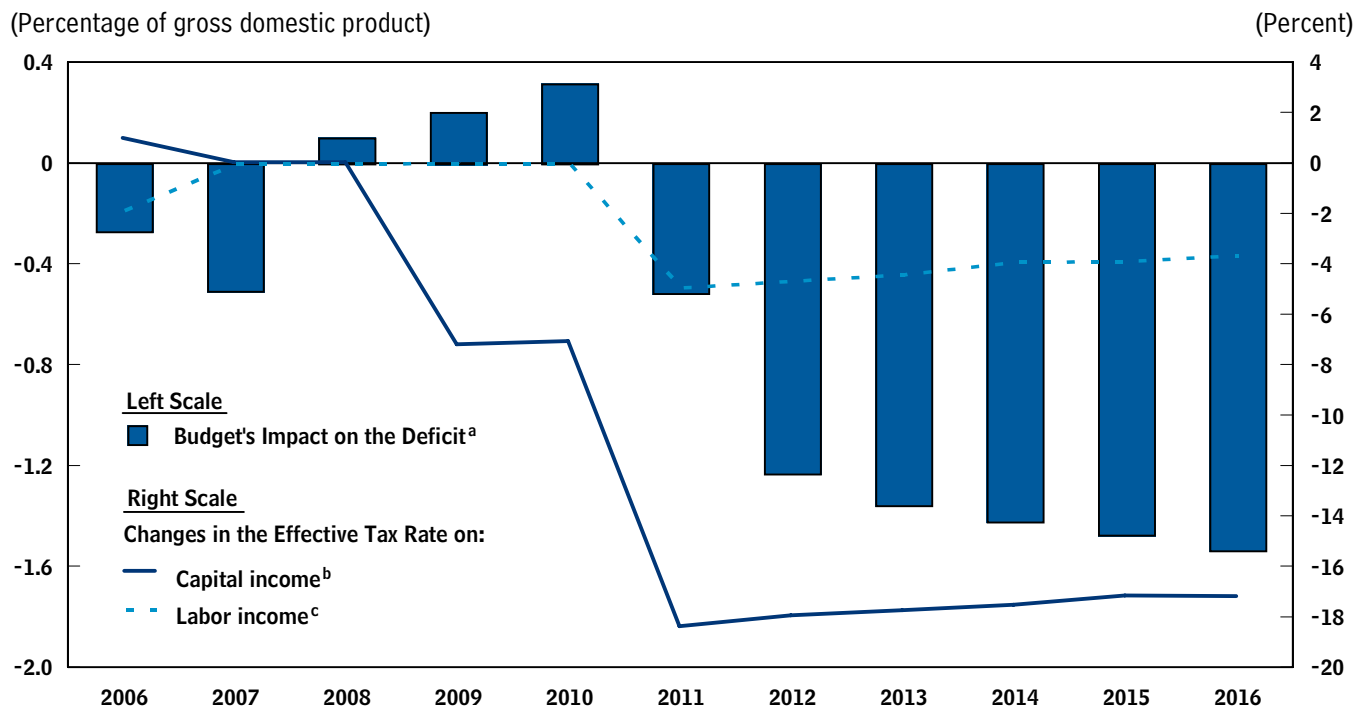
CBO used three growth models—a “textbook” growth model, a life-cycle growth model, and an infinite-horizon growth model—to analyze the supply-side effects of the President's proposals from 2007 through 2016 (the same period that CBO's baseline projections cover).⁵ The models differ in their assumptions about how far ahead people look in making their plans (see Appendix C). The textbook growth model is not forward-looking—it assumes that people do not explicitly take into account expected future policies in making current decisions. The life-cycle model incorporates the assumption that people make lifelong plans for working and saving but do not consider events that might occur after their death. By contrast, the infinite-horizon model incorporates the

4. CBO used two commercial macroeconomic models to estimate the demand-related effects of the President's proposals. In one of them, created by Global Insight, potential GDP responded positively to spending for research and development—which in turn would be stimulated by the proposal for extending tax credits for such activities.

5. CBO chose to analyze effects during the 2007-2011 and 2012-2016 periods for consistency with the periods presented in many of the tables in Chapter 1—despite the resulting exclusion of 2006, during which the President's proposals are estimated to have budgetary and economic effects. CBO's models showed positive supply-side effects on output in 2006 ranging from about 0.1 percent to 0.2 percent. The positive effects stemmed mainly from reduced tax rates on labor income as a result of the proposal to extend for one year the increase in the exemptions allowed under the alternative minimum tax.

Figure 2-2.

Effects of the President's Budget on the Deficit and on the Effective Tax Rates on Capital Income and Labor Income



Source: Congressional Budget Office.

Note: Effects on the deficit are by fiscal year; impacts on effective tax rates are by calendar year.

- The bars represent the effects of the President's proposals on the budget balance under CBO's baseline economic assumptions. A negative change indicates an increase in the annual deficit relative to CBO's baseline.
- Changes in the effective federal marginal tax rate on income from capital (the share of the last dollar of such income taken by federal individual income and corporate income taxes).
- Changes in the effective federal marginal tax rate on income from labor (the share of the last dollar of such income taken by federal individual income and payroll taxes).

Table 2-4.

CBO's Year-by-Year Forecast and Projections for Calendar Years 2006 Through 2016

	Estimated 2005	Forecast		Projected								
		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Nominal GDP (Billions of dollars)	12,494	13,262	13,959	14,696	15,455	16,208	16,954	17,718	18,512	19,329	20,178	21,064
Nominal GDP (Percentage change)	6.5	6.1	5.3	5.3	5.2	4.9	4.6	4.5	4.5	4.4	4.4	4.4
Real GDP (Percentage change)	3.6	3.6	3.4	3.4	3.3	3.0	2.8	2.7	2.6	2.6	2.6	2.5
GDP Price Index (Percentage change)	2.7	2.4	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Consumer Price Index ^a (Percentage change)	3.4	2.8	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index ^b (Percentage change)	2.2	2.2	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index ^c (Percentage change)	2.4	3.0	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.1	5.0	5.0	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	3.2	4.5	4.5	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Ten-Year Treasury Note Rate (Percent)	4.3	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Tax Bases (Billions of dollars)												
Corporate book profits	1,434	1,451	1,438	1,439	1,468	1,511	1,555	1,611	1,675	1,742	1,818	1,901
Wages and salaries	5,723	6,050	6,383	6,745	7,103	7,447	7,785	8,132	8,491	8,861	9,246	9,647
Tax Bases (Percentage of GDP)												
Corporate book profits	11.5	10.9	10.3	9.8	9.5	9.3	9.2	9.1	9.0	9.0	9.0	9.0
Wages and salaries	45.8	45.6	45.7	45.9	46.0	45.9	45.9	45.9	45.9	45.8	45.8	45.8

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year; GDP = gross domestic product.

a. The consumer price index for all urban consumers.

b. The consumer price index for all urban consumers excluding food and energy prices.

c. The employment cost index for wages and salaries of workers in private industry.

assumption that people care as much about the welfare of their descendants as they do about their own welfare. That assumption means that people behave as if they will live forever.⁶

CBO used the textbook growth model to estimate effects under two assumptions about the degree to which people will alter their hours of labor in response to changes in marginal tax rates: a “low” assumption, in which there is little response, and a “high” assumption, in which the response is at the upper end of the consensus of empirical estimates.⁷ Over the 2007-2011 period, on average, the President’s proposals under either assumption would have little effect on gross national product (GNP), in CBO’s estimation.⁸ Over the 2012-2016 period, the proposals would reduce GNP by 0.1 percent under the low assumption and raise GNP by 0.2 percent under the high assumption (see Table 2-5). Those estimates illustrate the budgetary proposals’ opposing effects, as estimated by the textbook growth model: higher deficits crowd out investment and thus reduce the capital stock, but lower marginal tax rates increase the labor supplied (especially in the last six years of the 2007-2016 period). Which effect dominates depends on the assumption made about how

sensitive the supply of labor is to changes in marginal tax rates.

The results of the textbook growth model differ from those of the other two growth models in large part because the textbook model does not incorporate forward-looking behavior: people, as the model represents them, do not shift hours of labor from the earlier to the later period and do not work and save more in anticipation of changes in policy after 2016. In addition, unlike the life-cycle and infinite-horizon models, the textbook growth model does not incorporate any direct effects on private consumption as a result of lower marginal (as opposed to lower average) tax rates and higher pretax interest rates.

The estimates that CBO produced using the life-cycle and infinite-horizon growth models are based on the assumption that people behave as if they believe that the budgetary policies being assessed—those of the President or of CBO’s baseline—will be maintained over the entire 10-year modeling period. That assumption is an important characteristic of CBO’s estimates. In reality, people would probably think that the policies might change at some point during that time.

Another characteristic of the estimates produced by the life-cycle and infinite-horizon models is that they depend in part on how the President’s budgetary proposals affect people’s expectations about fiscal policy beyond 2016. Assumptions about those expectations are complicated by the fact that the policies reflected in CBO’s baseline are likely to be unsustainable in the long run, owing to projected increases in spending for health and retirement programs.⁹ However, CBO assumed that people would expect the fiscal imbalances under current-law policies to be resolved—although the way in which that would happen is not specified. In projections that use its forward-looking models, CBO made explicit assumptions only about the manner in which increases in deficits under the President’s budgetary policies, relative to those in the baseline, would eventually be financed—not about the way that deficits projected in the baseline would be addressed.

The life-cycle and infinite-horizon models each generated two sets of estimates based on different assumptions about that financing (the models require such an assump-

6. Although the infinite-horizon model that CBO used in this year’s analysis of the economic effects of the President’s budgetary proposals is similar in spirit to the one it used last year, the model differs in a number of ways. Most important, the current model incorporates the assumption that income may vary unpredictably (in contrast to the former model’s assumption that future income is known with certainty) and that insurance against such fluctuations is unavailable. That assumption implies that people, as represented in the model, will hold some savings for “precautionary” reasons—as a buffer against drops in income. That practice in turn may imply that changes in the after-tax rate of return on savings will have less effect on consumption.

7. See Congressional Budget Office, *Labor Supply and Taxes* (January 1996).

8. In presenting the economic effects of the President’s budgetary proposals, CBO uses as its measure of output gross national product rather than the more commonly cited gross domestic product to better illustrate the proposals’ effects on the resources available to U.S. residents. In those circumstances in which capital can flow across borders, GDP may be a misleading guide to domestic incomes because foreigners may invest and earn returns from domestic production—which means that a portion of GDP is not included in U.S. income. GNP—the amount produced by U.S. residents and the capital they own anywhere in the world—provides a better measure of the United States’ resources in an open-economy context.

9. See Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005).

Table 2-5.

CBO's Estimates of How the President's Budget Would Affect Real Gross National Product

(Average percentage difference from CBO's baseline, by calendar year)

	2007 to 2011	2012 to 2016
Growth Models		
<i>Without Forward-Looking Behavior</i>		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	*	0.2
Low (Hours worked respond weakly to tax-rate changes)	*	-0.1
<i>With Forward-Looking Behavior</i>		
Closed-Economy Life-Cycle Model		
Lower government spending after 2016	*	0.6
Higher taxes after 2016	-0.1	0.5
Open-Economy Life-Cycle Model		
Lower government spending after 2016	*	0.7
Higher taxes after 2016	*	0.6
Infinite-Horizon Model		
Lower government spending after 2016	*	0.5
Higher taxes after 2016	*	0.7
Macroeconometric Models		
<i>Supply-Side Contribution</i>		
Macroeconomic Advisers' Model	*	n.a.
Global Insight's Model	0.1	n.a.
<i>Supply-Side and Demand-Side Contributions</i>		
Macroeconomic Advisers' Model	0.2	n.a.
Global Insight's Model	-0.3	n.a.

Source: Congressional Budget Office.

Notes: The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: in the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2016. CBO chose two alternatives—cutting government purchases of goods and services and transfer payments or raising marginal tax rates.

* = between -0.05 and 0.05 percent; n.a. = not applicable

tion because they are forward-looking). Under one assumption, people believe that the proposals will be financed by gradually reducing government spending for goods and services and for transfer payments (as shares of GNP) over the 2017-2026 period. Under the other assumption, people believe that the proposals will be financed by gradually increasing marginal tax rates over the same period.

Depending on which assumption about financing is used and whether the economy is considered to be open or closed to flows of foreign capital, the life-cycle model projects that the President's proposals will subtract (relative to CBO's baseline) up to 0.1 percent from GNP over the 2007-2011 period but then add between 0.5 percent and 0.7 percent over the 2012-2016 period. The difference between the projected effects over the two periods stems partly from the model's estimate that people will shift some hours of work from the earlier to the later period, when tax rates will be lower (relative to the assumptions of CBO's baseline).

The infinite-horizon model projects that the President's proposals will have little effect on GNP on average (relative to CBO's baseline) from 2007 to 2011. Depending on which assumption about financing is used, the model estimates that during the second five years of the modeling period, the President's proposals will add an average of between 0.5 percent and 0.7 percent to GNP. Once again, the difference in projected effects arises in part because the model estimates that people will shift some of their hours of work from the first five-year span to the second to take advantage of lower (relative to the baseline's assumptions) tax rates on labor income.

The effects on the economy from the President's proposed changes in fiscal policy would in turn affect the budget (see Table 2-1 on page 31 and Table 2-6). CBO projects that under the economic assumptions incorporated in its baseline, the President's proposals will expand the cumulative deficit over the 2007-2011 period by \$61 billion. Under the various assumptions used in the growth models that CBO employed in its analysis, the economic effects of the President's proposals over that period could add as much as \$9 billion to that total or subtract as much as \$10 billion from it.

For the 2012-2016 period, the President's budgetary policies under the baseline's economic assumptions are projected to boost the cumulative deficit by \$1,351 billion.

The economic effects of the President's proposals over that period, according to the models, could add as much as \$6 billion to that increase or subtract as much as \$170 billion from it. Most of the estimates indicate a reduction in the deficit as a result of those effects.

Five-Year Analysis Including Demand-Side Effects

To analyze how the President's budgetary proposals might affect both the demand side and the supply side of the economy over the next five years, CBO turned to macroeconomic forecasting models created by two private forecasting firms—Macroeconomic Advisers and Global Insight. Although the models include embedded growth models, their design concentrates on demand-side (cyclical) economic effects. Such effects become increasingly harder to estimate the further projections extend. Therefore, CBO used those models to produce estimates only for the first five years of the 2007-2016 period.

Like the textbook growth model, Macroeconomic Advisers' and Global Insight's models are not forward-looking—people, as the models represent them, do not behave as though they have specific expectations about future policies or economic developments. Instead, people respond to economic changes the same way they responded in the past, regardless of the source of the changes. For example, they react to those tax proposals in the budget that would boost after-tax labor income by increasing their purchases to about the same degree as they have, on average, in the past when after-tax labor income rose. However, people might increase their spending by a smaller amount in response to a change in taxes than they would in response to some other change that boosted their labor income (such as an increase in productivity) if they thought that tax legislation was more likely to be reversed in the future.

The lack of forward-looking behavior in the macroeconomic models implies that specific policy changes that are scheduled to occur in the future will not affect the current actions of people represented in the models unless special adjustments are made to mimic forward-looking behavior.¹⁰ For example, the President's proposal to extend many of the provisions in EGTRRA would reduce taxes (compared with the levels in CBO's baseline)

10. One such adjustment is that stock prices are assumed to incorporate the effects of extending lower rates on capital gains and dividend income immediately, even though the extension would not affect tax rates until after 2008.

Table 2-6.**The Budgetary Implications of the Macroeconomic Effects**

(Cumulative change from CBO's estimate of the President's budget, in billions of dollars)

	2007 to 2011	2012 to 2016
Growth Models		
<i>Without Forward-Looking Behavior</i>		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	7	52
Low (Hours worked respond weakly to tax-rate changes)	-1	-6
<i>With Forward-Looking Behavior</i>		
Closed-Economy Life-Cycle Model		
Lower government spending after 2016	-5	123
Higher taxes after 2016	-9	117
Open-Economy Life-Cycle Model		
Lower government spending after 2016	10	170
Higher taxes after 2016	5	164
Infinite-Horizon Model		
Lower government spending after 2016	-2	120
Higher taxes after 2016	5	147
Macroeconometric Models		
<i>Supply-Side Contribution</i>		
Macroeconomic Advisers' Model	4	n.a.
Global Insight's Model	11	n.a.
<i>Supply-Side and Demand-Side Contributions</i>		
Macroeconomic Advisers' Model	2	n.a.
Global Insight's Model	-27	n.a.

Source: Congressional Budget Office.

Notes: Numbers in this table reflect the effects on the cumulative deficit (relative to CBO's baseline) of the economic impacts shown in Table 2-4. (Negative numbers indicate an increase in the deficit; positive numbers, a reduction.) They do not include the estimated cost of the President's budgetary proposals under CBO's baseline economic assumptions. The total impact of the proposals on the cumulative deficit, including both those direct costs and the secondary effects shown above, appear in Table 2-1.

The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: in the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2016. CBO chose two alternatives—cutting government purchases of goods and services and transfer payments or raising marginal tax rates.

n.a. = not applicable.

in the years 2011 to 2016. Those lower taxes would increase the amount of after-tax income that people expected in the future, which might cause them to boost their spending today (as the forward-looking models imply). In the macroeconomic models, however, those changes in taxes affect people's consumption only when they occur.

The projections by Macroeconomic Advisers' and Global Insight's models also required an adjustment to the supply of labor. Like the textbook growth model, those models do not incorporate the effects of taxes on the number of hours worked. Therefore, CBO adjusted the models to incorporate its own estimates of those effects.¹¹

Two sets of estimates were produced to illustrate the magnitude of both demand- and supply-side effects in the models. For one set, CBO used the standard assumption that monetary policy would allow both demand- and supply-side effects. For the second set, CBO adjusted the model in such a way as to hold the unemployment rate at the level projected in its baseline. That approach produced an estimate of the implications of the proposals for potential (noncyclical) GNP—in other words, the supply-side effects.

Macroeconomic Advisers' model predicted that the demand- and supply-side effects of the President's proposed policies would raise GNP by 0.2 percent, on average, between 2007 and 2011 (see Table 2-5 on page 40). Global Insight's model, by comparison, estimated that the proposed policies would subtract an average of 0.3

percent from GNP over the same period. The difference arises largely from two factors:

- *The effect of government purchases on output.* Cumulative government purchases would be reduced under the President's proposals over the 2007-2011 period relative to the levels in CBO's baseline. Global Insight's model assumes that a given decline in purchases has a larger negative effect on GNP (through reduced demand) than does Macroeconomic Advisers' model.
- *The effect of stock prices on consumption.* CBO's analysis estimated that under the President's proposal to extend the lower dividend and capital gains taxes now set to expire in 2008, stock prices would rise. Macroeconomic Advisers' model assumes that such an increase will boost consumption by a greater amount than Global Insight's model assumes and therefore that it will have a more positive effect on GNP (through increased demand).

The models' estimates of the supply-side impacts of the President's proposals were more similar. Both macroeconomic models projected small supply-side effects under the President's budgetary policies: Macroeconomic Advisers' model estimated that output would be little changed, and Global Insight's model estimated that it would be 0.1 percent higher.

The projected economic impacts of the proposals would in turn affect the budget. According to the projections from Macroeconomic Advisers' model, the proposals' impact on the economy could subtract \$2 billion from the \$61 billion increase in the deficit projected for the 2007-2011 period under the baseline's economic assumptions (see Table 2-6). By the estimates of Global Insight's model, the supply-side and cyclical effects of the President's proposals over the same period could add \$27 billion to the deficit.

11. Using data from a large sample of taxpayers, CBO's estimates accounted for the effects of changes in both marginal tax rates and after-tax income under the President's proposals by incorporating a larger response to changes in marginal tax rates among secondary earners than among primary earners.

Changes to CBO's Baseline Since January 2006

In conjunction with its annual analysis of the President's budget, the Congressional Budget Office (CBO) typically updates the baseline projections that it published in its January report on the budget and economic outlook. Those projections—which are constructed according to rules set forth in law (primarily the Balanced Budget and Emergency Deficit Control Act of 1985)—project what spending and revenue levels would look like over the next 10 years if current laws and policies did not change (see Table A-1).

For revenues and mandatory spending, CBO is required to prepare baseline projections under the assumption that current laws continue unaltered in the future, with relatively few exceptions.¹ CBO projects discretionary spending by adjusting the current year's budget authority to reflect inflation and certain other factors specified in law. The resulting baseline estimates are not intended to predict future budgetary outcomes. Rather, they serve as neutral benchmarks that lawmakers can use to measure the effects of spending or revenue proposals, such as those in the President's budget.

Since January, CBO has reduced its projection of the cumulative deficit for the 2007-2016 period by \$106 billion, to \$726 billion (see Table A-2). Nearly all of that change stems from a decline of \$100 billion, or 0.3 percent, in projected outlays over that period—mainly because of the enactment of the Deficit Reduction Act of

2005 (Public Law 109-171). Revenue projections for the 10-year period are virtually unchanged since January, rising by a total of just \$6 billion.

Changes to Outlay Projections

Most of the revisions to CBO's spending projections in the past two months result from new laws, which have reduced the total outlays projected for the 2007-2016 period by \$124 billion. Technical changes (those attributable to factors other than legislation or economic variables) offset part of that reduction, increasing projected outlays by \$24 billion between 2007 and 2016.

Legislative Changes

The Deficit Reduction Act of 2005—also known as the spending reconciliation act—is responsible for almost all of the legislation-related changes to CBO's baseline since January.² CBO estimates that the law will reduce mandatory spending by \$106 billion over the 2007-2016 period.³ The largest savings are expected to occur in Medicaid, student loan programs, Medicare, and receipts from auctioning licenses to use the electromagnetic spectrum.

The reconciliation act will decrease net federal spending for Medicaid by a total of more than \$40 billion through 2016, CBO estimates. The bulk of those savings come from three changes: allowing state Medicaid programs to require beneficiaries to pay higher premiums and a

1. Among those exceptions, mandatory spending programs that are set to expire must be assumed to continue if they have outlays of more than \$50 million in the current year and were established on or before the enactment of the Balanced Budget Act of 1997. Programs established after that are not automatically assumed to continue. Similarly, the Deficit Control Act requires CBO to assume that expiring excise taxes that are dedicated to trust funds will be extended at their current rates. The law does not provide for the extension of other expiring tax provisions, even if they have routinely been extended in the past.

2. The budget resolution for 2006 instructed certain Congressional committees to recommend legislation that would reduce mandatory spending and revenues by specified amounts. That process is known as reconciliation.

3. For information about the effects of that law between 2006 and 2010—the period covered by the budget resolution for 2006—see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (January 2006), Box 1-2. Also see Congressional Budget Office, *Cost Estimate for S. 1932, the Deficit Reduction Act of 2005* (January 27, 2006).

Table A-1.**CBO's Baseline Budget Projections**

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007- 2011	Total, 2007- 2016
In Billions of Dollars														
Revenues														
Individual income taxes	927	1,003	1,108	1,190	1,281	1,374	1,572	1,724	1,824	1,930	2,043	2,164	6,525	16,210
Corporate income taxes	278	302	296	300	303	305	309	317	326	335	346	360	1,513	3,197
Social insurance taxes	794	838	882	925	970	1,017	1,064	1,112	1,161	1,212	1,264	1,319	4,857	10,926
Other	154	169	176	184	189	188	194	225	235	247	259	271	930	2,169
Total	2,154	2,313	2,461	2,598	2,743	2,883	3,139	3,378	3,546	3,725	3,913	4,114	13,825	32,502
On-budget	1,576	1,704	1,820	1,922	2,032	2,136	2,357	2,562	2,694	2,835	2,985	3,146	10,266	24,488
Off-budget	577	608	642	676	712	747	782	817	853	890	928	968	3,559	8,014
Outlays														
Mandatory spending	1,320	1,429	1,484	1,569	1,655	1,753	1,875	1,921	2,065	2,198	2,343	2,535	8,336	19,399
Discretionary spending	968	1,002	999	1,018	1,038	1,060	1,086	1,101	1,131	1,157	1,184	1,217	5,201	10,991
Net interest	184	218	243	262	274	286	295	298	297	296	294	291	1,361	2,838
Total	2,472	2,648	2,726	2,849	2,968	3,099	3,256	3,321	3,493	3,650	3,822	4,044	14,898	33,228
On-budget	2,070	2,220	2,280	2,388	2,488	2,601	2,739	2,777	2,921	3,046	3,183	3,366	12,494	27,788
Off-budget	402	428	447	461	480	498	517	543	572	604	639	678	2,403	5,440
Deficit (-) or Surplus	-318	-336	-265	-250	-224	-216	-117	58	53	74	91	70	-1,072	-726
On-budget	-493	-516	-460	-466	-456	-465	-382	-216	-227	-211	-198	-220	-2,228	-3,300
Off-budget	175	180	195	215	232	249	265	274	280	286	288	290	1,156	2,574
Debt Held by the Public	4,592	4,931	5,206	5,470	5,706	5,934	6,062	6,014	5,968	5,901	5,816	5,749	n.a.	n.a.
Memorandum:														
Gross Domestic Product	12,293	13,082	13,781	14,508	15,264	16,021	16,768	17,524	18,311	19,121	19,963	20,839	76,343	172,101
As a Percentage of Gross Domestic Product														
Revenues														
Individual income taxes	7.5	7.7	8.0	8.2	8.4	8.6	9.4	9.8	10.0	10.1	10.2	10.4	8.5	9.4
Corporate income taxes	2.3	2.3	2.1	2.1	2.0	1.9	1.8	1.8	1.8	1.7	1.7	1.7	2.0	1.9
Social insurance taxes	6.5	6.4	6.4	6.4	6.4	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.4	6.3
Other	1.3	1.3	1.3	1.3	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.2	1.3
Total	17.5	17.7	17.9	17.9	18.0	18.0	18.7	19.3	19.4	19.5	19.6	19.7	18.1	18.9
On-budget	12.8	13.0	13.2	13.2	13.3	13.3	14.1	14.6	14.7	14.8	15.0	15.1	13.4	14.2
Off-budget	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.6	4.6	4.7	4.7
Outlays														
Mandatory spending	10.7	10.9	10.8	10.8	10.8	10.9	11.2	11.0	11.3	11.5	11.7	12.2	10.9	11.3
Discretionary spending	7.9	7.7	7.3	7.0	6.8	6.6	6.5	6.3	6.2	6.1	5.9	5.8	6.8	6.4
Net interest	1.5	1.7	1.8	1.8	1.8	1.8	1.8	1.7	1.6	1.5	1.5	1.4	1.8	1.6
Total	20.1	20.2	19.8	19.6	19.4	19.3	19.4	19.0	19.1	19.1	19.1	19.4	19.5	19.3
On-budget	16.8	17.0	16.5	16.5	16.3	16.2	16.3	15.8	16.0	15.9	15.9	16.2	16.4	16.1
Off-budget	3.3	3.3	3.2	3.2	3.1	3.1	3.1	3.1	3.1	3.2	3.2	3.3	3.1	3.2
Deficit (-) or Surplus	-2.6	-2.6	-1.9	-1.7	-1.5	-1.3	-0.7	0.3	0.3	0.4	0.5	0.3	-1.4	-0.4
On-budget	-4.0	-3.9	-3.3	-3.2	-3.0	-2.9	-2.3	-1.2	-1.2	-1.1	-1.0	-1.1	-2.9	-1.9
Off-budget	1.4	1.4	1.4	1.5	1.5	1.6	1.6	1.6	1.5	1.5	1.4	1.4	1.5	1.5
Debt Held by the Public	37.4	37.7	37.8	37.7	37.4	37.0	36.2	34.3	32.6	30.9	29.1	27.6	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

Table A-2.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since January 2006

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007- 2011	Total, 2007- 2016
Total Deficit (-) or Surplus as Projected in January 2006	-337	-270	-259	-241	-222	-114	38	40	57	73	67	-1,107	-832
Changes to Revenue Projections (Technical)	*	*	*	1	1	1	1	1	1	1	1	3	6
Changes to Outlay Projections													
Legislative													
Mandatory	-5	4	-4	-21	-12	-12	-14	-13	-11	-11	-12	-46	-106
Discretionary	0	1	1	1	1	1	1	1	1	1	1	3	7
Net interest (Debt service)	*	*	*	-1	-1	-2	-3	-3	-4	-5	-6	-5	-25
Subtotal, legislative	-5	4	-4	-21	-13	-13	-16	-15	-14	-15	-16	-47	-124
Technical													
Mandatory													
Medicare ^a	-5	-4	1	6	11	22	2	11	11	12	28	36	102
Medicaid	-1	-1	-1	-2	-3	-5	-6	-8	-10	-12	-15	-12	-63
Social Security	*	*	1	1	1	1	2	2	2	2	2	4	13
Other	7	-3	2	4	1	2	2	2	*	3	4	6	16
Subtotal, mandatory	1	-8	2	9	10	20	*	7	3	5	20	34	68
Discretionary	3	-1	-5	-3	-1	-2	-2	-2	-3	-3	-3	-12	-25
Net interest													
Debt service	*	*	*	*	*	1	1	1	1	1	1	2	7
Other	*	-1	-2	-2	-2	-2	-3	-3	-4	-4	-4	-9	-26
Subtotal, net interest	*	*	-2	-2	-2	-1	-2	-2	-2	-3	-3	-7	-19
Subtotal, technical	4	-9	-5	5	7	17	-4	2	-2	-1	14	15	24
Total Outlay Changes	-1	-5	-8	-16	-6	4	-20	-13	-16	-17	-2	-32	-100
Total Impact on the Deficit or Surplus^b	1	6	9	17	7	-3	20	13	17	17	3	35	106
Total Deficit (-) or Surplus as Projected in March 2006	-336	-265	-250	-224	-216	-117	58	53	74	91	70	-1,072	-726
Memorandum:													
Total Legislative Changes ^b	5	-4	4	21	13	13	16	15	14	15	16	47	124
Total Technical Changes ^b	-4	10	5	-4	-6	-16	5	-2	3	2	-13	-12	-18

Source: Congressional Budget Office.

Note: * = between -\$500 million and \$500 million.

a. Includes offsetting receipts.

b. Negative numbers indicate an increase in the deficit or decrease in the surplus.

greater share of their health care costs, letting states reduce coverage for some beneficiaries, and lowering Medicaid's payments for outpatient prescription drugs.

Provisions of the Deficit Reduction Act that affect student loan programs are estimated to produce net savings of \$4 billion in 2006 and \$30 billion over the next 10 years. Changes that reduce spending include lowering payments to lenders, raising the interest rate charged on loans to students' parents, mandating that guaranty agencies pay certain fees, reducing lenders' insurance reimbursements, and eliminating mandatory funding for administrative costs. Those changes are partly offset by provisions that increase federal spending for student loans, such as raising annual borrowing limits, reducing the loan-origination fees that the government collects from borrowers, and creating two new grant programs.

The reconciliation act decreases spending for Medicare by an estimated \$21 billion over the 2007-2016 period. Part of the savings result from lowering payments for certain imaging services (such as magnetic resonance imaging, or MRI) and for home health services. Savings also come from improving the accuracy of the process by which Medicare adjusts payments to managed care plans for differences in expected costs that stem from differences in patients' health status.

The Deficit Reduction Act also includes provisions that will increase collections from the Federal Communications Commission's auctions of spectrum licenses, raise the premiums that companies pay to the Pension Benefit Guaranty Corporation for pension insurance, and modify other mandatory programs. Those provisions reduce projected spending by \$15 billion over the 2007-2016 period.

Besides enacting the Deficit Reduction Act, the Congress and the President recently transferred \$712 million from balances in the Federal Emergency Management Agency's Disaster Relief Fund to the Small Business Administration for disaster loans to aid victims of Hurricanes Katrina, Rita, and Wilma. Extrapolating that funding through 2016 adds \$7 billion to CBO's baseline projection of discretionary spending over the 10 years.

In all, changes directly related to recent legislation have reduced CBO's projection of the cumulative deficit for the 2007-2016 period by \$99 billion. In turn, that reduction means less borrowing by the federal govern-

ment, which decreases projected debt-service costs over the 10-year period by \$25 billion.

Technical Changes

Technical revisions to the baseline since January have raised projected outlays between 2007 and 2016 by a total of \$24 billion. Much of that rise comes from an increase in estimated spending for Medicare, partly offset by reductions in projected spending for Medicaid and for discretionary programs.

Medicare. Although CBO lowered its projection of Medicare spending over 10 years because of provisions in the Deficit Reduction Act, it added \$102 billion to that projection because of new information about recent spending. That increase is the result of a \$148 billion (3 percent) rise in projected net spending for Parts A and B of Medicare and a \$46 billion (5 percent) reduction in projected net spending for the prescription drug benefit under Part D. (Those amounts reflect changes in both gross outlays and receipts from premium payments.)

In 2005, Medicare spending grew at its fastest rate in a decade—by 10 percent (taking into account the effect of shifts in the timing of payments to managed care plans). Rapid growth has continued through February of this year. As a result, CBO has raised its estimate of the rate at which spending for Part A and B benefits will increase in the future. It now expects that growth rate to be 9 percent in 2006 and to average 6.9 percent annually between 2006 and 2016 (compared with a 6.6 percent average in CBO's January baseline).

Nearly all of the reduction in projected spending for Part D over 10 years reflects updated information about national spending for prescription drugs in 2004 and 2005. On the basis of actual spending in 2004—which was about 4 percent lower than expected—and estimated spending in 2005, CBO now anticipates that spending for prescription drugs throughout the coming decade will be about 6 percent lower than projected in January. For that reason and because of current enrollment figures, CBO has also reduced its estimate of net spending for Part D in 2006 by \$4.4 billion.

Medicaid. Technical changes have lowered CBO's projection of federal Medicaid spending over the 2007-2016 period by \$63 billion. Those changes are based on CBO's analyses of data on Medicaid spending and enrollment from the Centers for Medicare & Medicaid Services.

Those data indicate slower-than-expected growth in per capita spending in several areas—particularly long-term care services and prescription drugs. Some of the decrease from slower growth in per capita spending is offset by increases in expected enrollment of people with disabilities. Overall, CBO now projects that Medicaid spending will grow at an average annual rate of 7.5 percent from 2007 to 2016, compared with 8.0 percent in the January baseline.

Social Security. Additional information about Social Security recipients has led CBO to revise its projections slightly. Those changes—chiefly, boosting the average initial retirement benefit expected in the Old-Age and Survivors Insurance program and shaving the number of recipients and the average payment expected in the Disability Insurance program—have opposite effects on the two programs' benefits. On balance, they increase estimates of Social Security outlays by roughly \$1 billion per year for 2008 through 2011 and by \$2 billion per year (approximately 0.2 percent of total benefits) thereafter, for a total increase over the projection period of \$13 billion.

Other Mandatory Programs. The remaining technical changes to CBO's baseline projections of mandatory spending involve a number of programs. For example, projected outlays for the Universal Service Fund over 10 years have risen by \$8 billion because of anticipated growth in spending for telecommunications services in high-cost areas. That increase in outlays is roughly offset by an equal increase in estimated revenues. Projected outlays from the Military Retirement Fund have risen by \$7 billion because of revised estimates by Defense Department actuaries of the future population of military retirees and their survivors.

Discretionary Programs. Whereas technical changes to CBO's baseline since January have increased projections

of mandatory spending, they have decreased estimates of discretionary outlays. Those decreases reduce the cumulative deficit projected for the 2007-2016 period by \$25 billion.

The biggest change reflects new information from the Department of Defense about the allocation of budget authority for pay and nonpay purposes, which affects the overall inflation rate used to project defense spending. On the basis of that information, CBO has reduced its baseline projection of budget authority for national defense, which reduces projected defense outlays over the 2007-2016 period by roughly \$14 billion. Other, smaller adjustments have lowered projected outlays by \$11 billion over that 10-year period.

Net Interest. CBO has also trimmed \$26 billion from its estimate of net interest costs over the 2007-2016 period because of changes to certain intragovernmental interest payments, changes in the estimated balances of financing accounts for federal loan programs, and updated information about the stock of debt held by the public. (Two-thirds of that reduction occurs in the last five years of the projection period.) In the other direction, increases in deficits—and thus in debt-service costs—because of technical changes to spending and revenue projections add \$7 billion to net interest outlays over the 10-year projection period.

Changes to Revenue Projections

Revisions to CBO's revenue projections since January have been far smaller than the changes to outlay projections. Those revisions are entirely technical, reflecting higher projections of miscellaneous fees and fines (mainly the ones that finance the Universal Service Fund). The changes add less than \$500 million to projected revenues in 2006 and growing amounts thereafter, for a total increase over the 2007-2016 period of \$6 billion.

The Potential Economic Effects of Selected Proposals in the President's 2007 Budget

Considerable uncertainty surrounds the potential economic effects of four of the President's budgetary proposals for 2007—those that would extend beyond 2008 the dividend and capital gains tax rates enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), expand the availability of tax-free savings accounts, extend the repeal of the estate tax, and establish individual accounts as part of Social Security. Discussed below are the factors that the Congressional Budget Office (CBO) considered and the methods it used in assessing those effects. (CBO's analysis of the overall economic impact of the President's budgetary proposals is described in Chapter 2.)

Extend JGTRRA's Dividend and Capital Gains Tax Rates

The enactment of JGTRRA in 2003 reduced tax rates applicable to both dividends and capital gains for the years 2003 through 2008. Those rates comprise a bottom bracket of 5 percent and a top bracket of 15 percent; in 2008, the bottom bracket is slated to drop to zero. Before JGTRRA was enacted, dividends were subject to the same tax rates as those on ordinary income—ranging from 10 percent to 38.6 percent—and most capital gains were subject to rates of 8 percent, 10 percent, or 20 percent. The President, in his 2007 budget, has proposed making the zero and 15 percent rates permanent.

Such reduced rates would lower the overall taxation of corporate profits, some of which are taxed once under the corporate income tax and then again, when people receive dividends and realize capital gains—brought about by the firm's reinvestment of its profits—on sales of stock. Lowering the tax rates that individuals face on the two types of income would reduce the total rate of taxation.

In lowering tax rates, JGTRRA not only reduced the taxation of corporate income but also lowered taxes on some income that is currently taxed only once. A substantial portion of taxable capital gains arises from investments whose earnings are not subject to the corporate income tax, such as gains on real estate held by individuals. The lower capital gains tax rate cut the level of taxation on those investments as well.

To some extent, the economy is already feeling the effects of JGTRRA's reductions in rates on dividends and gains. However, the short duration of those lower rates—they are scheduled to expire after 2008—lessens their effect on investment and the capital stock. Much productive capital is long-lived, and firms will not fully adjust their investment plans for changes in tax policy that are due to expire before that investment is taken out of service. Thus, some of the potential effects of the current rates can be expected to occur only if the proposed extension of those rates becomes law.

One such effect involves the cost of financing for businesses. By reducing the overall taxation of capital income, a drop in taxes on dividends and capital gains might be expected to lower that cost, because businesses could pay investors less before taxes to yield the same after-tax return. But how much the cost of capital might fall is unclear. Some analysts argue that only the decrease in taxes on capital gains will act to reduce that cost. Others hold that both the decrease in taxes on dividends and the decrease in taxes on capital gains will reduce the cost of capital.¹

1. See George R. Zodrow, "On the 'Traditional' and 'New' Views of Dividend Taxation," *National Tax Journal*, vol. 44, no. 4 (December 1991), pp. 497-509.

A related difference of opinion among analysts involves how much the value of firms' stock might rise if the lower rates were extended. (Share values rise because the decrease in taxes increases the after-tax return to shareholders.)² The view of corporate finance that predicts a relatively large increase in those values predicts a relatively small decrease in the cost of capital, and vice versa.

In the absence of a consensus about which view is correct, CBO has adopted middle-ground estimates of the effects of the President's proposal on the cost of capital for firms and on share values.

High values for shares of stock lead to more spending by shareholders on goods and services (the so-called wealth effect). Therefore, the President's proposal will help boost overall demand in the short run. But the more it helps demand by raising consumption, the more it will hurt supply in the long run, by reducing saving and investment.

Extending the rates on capital gains and dividends is also likely to lessen the disadvantage that the corporate sector now faces in the competition for capital. For example, although some income from the corporate sector is taxed twice under current law, income from unincorporated businesses is taxed only once (at the personal level), and the value of the housing "services" provided by owner-occupied housing is not taxed at all. That disparity in tax treatment leads to less investment in the corporate sector than may be optimal for economic output. Lowering the taxes that firms face would allow them to attract additional capital from the housing and small-business sectors and in general improve the economy's efficiency. Such a shift in investment might, however, conflict with other policy goals, such as support for owners' occupancy of homes or for unincorporated businesses.

The proposal might affect firms' financial behavior in two ways: firms might choose to finance investment by issuing stock (equity financing) rather than debt, and they might decide to pay dividends rather than retain earnings. Currently, firms may deduct the interest they pay on debt from their taxable income, so those payments are taxed only once, at the personal level. (That is, the indi-

vidual who receives the payment pays the tax.) But if a firm finances a project by issuing stock, some of the returns on the investment that the project generates are taxed at both the corporate and personal levels. The President's proposal would narrow that disparity in tax treatment.

The proposed reduction in the future taxation of dividends and capital gains would also interact with some of the President's other proposals and with current law. For instance, the President's proposal to boost the amount that people may deposit in tax-free savings accounts (discussed below) would increase the share of personal assets held in such accounts—duplicating some of the effect that the proposal to extend the tax rates on dividends and capital gains would have on the cost of capital and its allocation among sectors of the economy. However, the expanded accounts would partly undo the impact that the dividend/capital gains proposal would have in bolstering equity financing because the interest earned on assets in the accounts would not be taxed at either the personal or the corporate level. Also contributing to that smaller impact on equity financing would be the combined effect of the two policies in increasing the proportion of interest-bearing assets in tax-free accounts: the incentive to hold stocks in such accounts would be weakened if their returns already faced lower tax rates.

CBO incorporated the effects of the dividend/capital gains proposal in its analysis in two ways. For the two macroeconomic models (the models CBO used in its analysis are discussed in Appendix C), CBO estimated the proposal's effect on the cost of capital in different sectors of the economy and on the value of stock shares under the assumption that both investors and businesses are forward-looking. It then incorporated those estimates in the models and projected the ultimate effect on the economy.

For the growth models, CBO estimated the proposal's overall effect on the average cost of capital and incorporated that calculation. Those models, however, have no mechanism to account for the effect of reallocating capital. CBO therefore reviewed research on how reallocation might influence output, determined a midrange estimate, and added that amount to the models' underlying estimates of the effect on output. The procedure phased in an increase in gross national product over the 2006-2016 period that reached 0.07 percent in 2016.

2. Over time, however, increased investment will enlarge the capital stock, in turn reducing the pretax rate of return and offsetting at least some of the impact of the reduction in taxes.

Expand Tax-Free Savings Accounts

The President's 2007 budget includes a proposal that is designed to both consolidate and expand the current system of tax-free savings accounts for retirement and other purposes, such as education. Two new kinds of accounts would be created: retirement savings accounts (RSAs) and lifetime savings accounts (LSAs). The RSA would function in some ways like a Roth individual retirement account (IRA)—that is, taxes would not be deferred on contributions, as they are for contributions to traditional IRAs, but the interest that the accounts earned would accrue tax-free. In contrast to Roth IRAs, however, RSAs would be available to all workers (and their spouses) regardless of income; they would also have higher limits on contributions and allow penalty-free withdrawals at a slightly earlier age. In addition, the President's proposal would eliminate further tax deferrals for IRA contributions.

Like the RSAs, the proposed lifetime savings accounts would face tax treatment similar to that governing Roth IRAs. However, unlike Roth IRAs or RSAs, LSAs would be open to everyone, regardless of age, income, or employment status, and participants could withdraw funds at any time for any reason. Taxpayers could also use LSAs to consolidate other savings plans, including Coverdell education savings accounts and qualified state tuition plans.

In CBO's estimation, the new savings accounts that the President has proposed would have little effect on the economy, on average, over the 2007-2016 period. Most taxpayers would save similar amounts in one of the new accounts as they would have saved in one of their present tax-free accounts. One possible outcome of implementing the new accounts is that people who currently have assets in taxable accounts will reduce their tax liability by selling those assets and putting the proceeds into the new accounts. However, that action would create no new saving and thus would have no effect on the total amount of private saving. Most new saving would involve small amounts set aside by taxpayers with few taxable assets to shift.

Beyond 2016, the effects of the proposal might be greater than those just described (because increasing numbers of taxpayers would run out of assets that could be shifted). In later years, the proposal would have a modestly positive impact on saving, CBO estimates.

Extend the Estate Tax's Repeal

The President's proposal to extend the repeal of the estate tax beyond the end of 2010 (the repeal's scheduled expiration date) could have varying effects on consumption and saving, depending on people's motives for leaving bequests. Yet consensus is lacking about which motives predominate or even about whether people intentionally save in order to make bequests. On the one hand, people might save additional amounts for bequests to enhance their children's welfare, to enjoy the feeling of being generous, or to influence the behavior of their heirs. On the other hand, the desire to make bequests might have little influence on saving; some people might acquire wealth largely for other purposes and leave it as a bequest if they die before they expect to. In that case, extending the repeal of the estate tax would have little effect on saving.

Also in dispute, even among analysts who believe that estate taxes affect consumption and saving, is the direction of the effect. A lower estate tax makes it cheaper for people to leave money to their heirs, which could encourage people to save more to leave larger bequests. But a lower estate tax also means that people can make the same after-tax bequest with a smaller amount of savings, which might induce them to save less. Furthermore, to the extent that a lower estate tax increases the size of bequests after taxes, potential recipients may increase their consumption. Some opponents of the estate tax argue that it has a particularly negative effect on the creation of new small businesses, but CBO found little evidence to support that contention.

CBO's estimates of the effects of the President's proposal incorporated the assumption that extending the repeal of the estate tax would increase consumption slightly, on balance, by about 5 cents for each dollar of tax savings.³ Alternative assumptions that CBO considered—for example, that the positive effect on consumption from increasing after-tax income is exactly balanced by the incentive effects of lower tax rates, yielding no net impact on consumption—would have yielded similar results.

3. CBO assumed that consumer spending would increase by a small amount because recipients of after-tax bequests would be unlikely in any given year to raise their spending by a significant amount and because the effect on recipients might be offset to some degree by increased saving among those planning to leave bequests.

Establish Individual Accounts in Social Security

The President's budget includes a proposal that would allow workers to redirect a portion of their payroll tax payments from the Social Security trust funds to individual accounts and invest the contributions to such accounts in various financial assets. In CBO's estimation, the proposal would result in budgetary outlays of \$312 billion from 2009 to 2016; however, it would have no appreciable effect on the economy during that period because it would not change people's projected lifetime income (once the expected returns of the assets in the accounts were adjusted for the risk they carry) and would not alter people's take-home pay. In addition, the accounts would not have a direct effect on the investment capital available in the economy because the additional government borrowing needed to finance the accounts would be offset by the increase in investable funds in the accounts.

Under the proposal, workers could redirect payroll taxes to individual accounts, but the contributions to the accounts would ultimately be offset by reductions in traditional benefits that would be calculated by using hypothetical accounts. In addition to tracking the actual balances in an individual account, the Social Security Administration would follow a hypothetical account that held the same amount of contributions and that grew at a specified real (inflation-adjusted) rate of 2.7 percent per year. When the person claimed traditional Social Security benefits, those benefits would be cut back in such a way that the actuarial value of the reduction over the person's remaining lifetime would equal the amount in the hypothetical account—regardless of how much was actually in the person's individual account.

The rate of growth for the hypothetical account is derived from projections by the trustees of the Social Security system. In their estimation, Treasury bonds over the long

run will earn an average real return of 3 percent, and the individual accounts, if enacted, will incur annual administrative expenses equal to 0.3 percent of assets—for a net real return of 2.7 percent. Because that rate equals the rate of return on the hypothetical account that would be used to calculate the reduction in benefits, diverting payroll taxes to an individual account and investing entirely in government bonds is projected to leave a person's total benefits (including the account assets) unchanged. If, however, the average rate of return on government bonds turns out to be higher or lower than that projected 3.0 percent, the total benefits of a person who chose to divert some payroll taxes to an individual account and invest in Treasury bonds will also be higher or lower.

On average, higher returns would be expected from investing the contributions to an individual account in other assets, such as corporate bonds or equities. However, those investments would also be riskier than government bonds. Market trading establishes the prices of various assets and their expected returns, both of which are determined by the preferences and judgments of market participants who attempt to balance the risks of various assets against their extra expected returns. Therefore, despite the fact that an individual account holding assets such as stocks (with an expected return higher than 2.7 percent) would yield expected lifetime Social Security benefits whose value was greater than it would be under the traditional system, that higher anticipated income would not be expected to change the account holder's behavior (by, for example, inducing him or her to increase consumption) because the higher expected return would be balanced by additional risk. Shifting some payroll taxes to an individual account would also be unlikely to affect the consumption of people who spend all of their income because it would not alter their take-home pay.

The Models Used to Analyze the Supply-Side Macroeconomic Effects of the President's Budget

The Congressional Budget Office (CBO) used three models to estimate the supply-side effects of the President's budget from 2007 to 2016: a "textbook" growth model, a life-cycle growth model, and an infinite-horizon growth model. (The estimates that those models generated are presented in Chapter 2.)

Textbook Growth Model

The textbook growth model is an enhanced version of a model developed by Robert Solow, a pioneer in the theory of growth accounting.¹ The textbook growth model incorporates the assumption that output is determined by the number of hours of labor supplied by workers, the size and composition of the capital stock (for example, factories and information systems), and total factor productivity—which represents the state of technological know-how. The model is not forward-looking; the people that it represents base their decisions entirely on current economic conditions. In particular, they do not respond to expected future changes in government policy. Nor does the model incorporate effects from demand-side, or cyclical, variations in the economy. Rather, it assumes that output is always at its potential level.

The estimates that CBO developed using the textbook growth model incorporate the effects that changes in marginal tax rates specified in the President's budget would have on the number of hours worked. (CBO estimated the tax-rate effects in a separate calculation.) Those effects would be greatest between 2011 and 2016,

when lower marginal tax rates would increase the supply of labor relative to its estimated level in CBO's baseline.

Because they would increase federal deficits over the 10-year budget window, the President's budgetary proposals are projected to have a negative effect on the capital stock in the textbook growth model. The proposals would increase after-tax income relative to its level in the baseline, which would lead to greater private consumption that in turn would crowd out investment. In the textbook growth model, changes in marginal tax rates on capital have no direct effect on spending by the private sector.

The negative effects on the capital stock would be partially offset by two factors, which the model accounts for by including assumptions based on past relationships. First, the increase in private consumption would be moderated by the assumption that people increase their private saving by 40 cents for every dollar that the deficit increases. That assumption implies that every dollar of deficit reduces national saving—government plus private saving—by 60 cents. Second, for every dollar that the level of national saving falls, the amount of foreign capital invested in the United States is assumed to increase by 40 cents. Together, those figures imply that a one-dollar increase in the deficit results in a 40 cent increase in private saving, a 24 cent increase in capital inflows (24 cents equals 60 cents times 0.4), and a 36 cent decline in domestic investment.

The Life-Cycle and Infinite-Horizon Growth Models

The other models that CBO used in its supply-side analysis—the life-cycle and infinite-horizon growth models—differ in fundamental ways from the textbook growth

1. For a detailed description of the textbook growth model, see Congressional Budget Office, *CBO's Method for Estimating Potential Output: An Update* (August 2001).

model.² The life-cycle and infinite-horizon models incorporate simulated people who make decisions about how much to work and save to make themselves as well off as possible over their lifetime. Their behavior is calibrated so that such macroeconomic variables as the total amount of labor supplied and the size of the capital stock match the levels of those variables in the U.S. economy. In the life-cycle and infinite-horizon growth models, people's consumption changes by a relatively large amount in response to changes in the after-tax rate of return on their savings. Like the textbook growth model, those models do not allow for any demand-side effects.

The people in the life-cycle and infinite-horizon models are assumed to be forward-looking—that is, they know how economic conditions and policy will change in the future and alter their behavior accordingly. In terms of the degree to which people incorporate future events into their current behavior, that “perfect foresight” is at the other end of the range of possibilities from the assumption used in the textbook growth model. Most people's foresight actually falls somewhere between those two extremes. However, in using those two somewhat dramatic assumptions, CBO has tried to encompass as broad a range of possible responses to the President's budgetary proposals as is feasible.

Because people's behavior as represented in the life-cycle and infinite-horizon growth models depends in part on future policies, the use of those models requires analysts to make assumptions about budgetary policies beyond 2016 (the end of the period covered by CBO's current 10-year baseline projections). Policies that increase deficits must be offset at some point in the future by taxes that are higher or spending that is lower than it would have been in the absence of those higher deficits.

Assumptions about how and when to finance the increased deficits can influence the estimated economic effects of the President's proposed policies over the 2007-2016 period. That impact stems from the fact that in the

models, people anticipate the offsetting policies and plan accordingly. In its analysis, CBO used two different assumptions about how the budget would be stabilized after 2016: either marginal tax rates would be increased, or government spending would be reduced (spending reductions are assumed to be spread roughly equally among government purchases of goods and services—which the models assume do not substitute for private consumption—and transfer payments). Both the increase in marginal tax rates and the reductions in government spending would be phased in over 10 years, beginning in 2016.

The life-cycle and infinite-horizon growth models differ in what they assume about how far ahead people look in making their plans. The life-cycle model is calibrated so that the probability of death at a given age matches current U.S. mortality rates and people are assumed to take account of the impact of future economic or policy changes only for themselves and not for their children. In the infinite-horizon model, people behave as though the well-being of their descendants is as important to them as their own well-being—which leads them to behave as if they expected to live forever. Although the possibility that such an assumption reflects actual behavior cannot be ruled out, there is some evidence against it.³

The difference in the models' time horizons has an important effect on the resulting estimates. The people in both models expect the increase in deficits under the President's budgetary proposals to be offset at some point in the future. However, people as represented in the life-cycle model, especially older individuals, know that they may die before an offsetting policy change occurs. Consequently, they may be less willing to work or save more during the 10-year projection period to compensate for any future tax increases or cuts in transfer payments.

By contrast, people in the infinite-horizon model act as though they (or, equivalently, their descendants, whom they care about as much as they do themselves) will be alive when the offsetting policy change is made. That ex-

2. For a detailed description of the life-cycle model, see Shinichi Nishiyama, “Analyzing Tax Policy Changes Using a Stochastic OLG Model with Heterogeneous Households,” Technical Paper 2003-12 (December 2003), available at www.cbo.gov/publications/bydoctype.cfm?dtype=8. For a description of a model very similar to the infinite-horizon model, see S. Rao Aiyagari, “Uninsured Idiosyncratic Risk and Aggregate Saving,” *Quarterly Journal of Economics*, vol. 109, no. 3 (August 1994).

3. See Paul Evans, “Consumers Are Not Ricardian: Evidence from Nineteen Countries,” *Economic Inquiry*, vol. 31, no. 4 (October 1993), pp. 534-548; Fumio Hayashi, Joseph Altonji, and Laurence Kotlikoff, “Risk Sharing Between and Within Families,” *Econometrica*, vol. 64, no. 2 (March 1996), pp. 261-294; and T.D. Stanley, “New Wine in Old Bottles: A Meta-Analysis of Ricardian Equivalence,” *Southern Economic Journal*, vol. 64, no. 3 (January 1998), pp. 713-727.

pectation implies that people's belief about taxes increasing in the future may have a greater effect on their current work and saving than it may have for people in the life-cycle model.

CBO used a different infinite-horizon model for this year's analysis than it had used in the past, and the new model yielded estimates closer to those of the life-cycle model. The current infinite-horizon model incorporates unforeseeable fluctuations in income. That feature, together with an assumption that insurance against changes in income is not available, implies that people, as represented in the model, will hold some savings for "precautionary" reasons—as a buffer against drops in income. That practice in turn may imply that anticipated changes in policy will have less effect on current behavior.

The degree to which an economy is open to the flow of foreign capital is important because it determines both how easily domestic investment can be financed by sources other than domestic saving and the degree to which budgetary policies can affect wage and interest rates. CBO used two different assumptions in the life-cycle model about how open the economy is to flows of capital to and from other countries. One assumption was that the economy is completely closed—no capital can flow into or out of the United States. The other assumption was that the economy is completely open and cannot affect world interest rates—capital flows freely into and out of the country to keep the domestic interest rate equal to a constant world rate. The U.S. economy effectively operates somewhere between those two extremes because even though it is relatively open to investment, it is so large that it can influence world interest rates.

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Revenue Projections

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